



**RIGA  
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LAW**

**The application of the Market Economy Investor Principle to  
assess the existence of economic advantage in case of  
differentiated airport charges of the European Union's airports**

**MASTER'S THESIS**

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**DECLARATION OF HONOUR:**

I declare that this thesis is my own work, and that all references to, or quotations from, the work of others are fully and correctly cited.

(Signed).....

## Summary

Commercial aviation market is one of the fastest growing and most liberalised sectors of economy in the EU. Development of low cost carriers changed the aviation world as regional airports experienced a boost of traffic and prospects of their financial sustainability.

On the other hand, expansion of low cost carriers in the EU airports resulted in many complaints from full service airlines. This resulted in development of case law, both at the Commission and the CJEU level.

According to the case law, price differentiation of airport charges is not considered as granting of economic advantage to particular undertaking if a market economy operator had adopted a similar practice guided by the prospects of long term profitability.

The Master's Thesis includes an analysis of State aid cases of the Commission and judgements of the CJEU concerning the application of the MEIP with regard to agreements concluded among airports (airport managing bodies) and airport users (airlines).

The Master's Thesis addresses the methodological issues of the MEO test in the context of airports' business models and determination of airport charges.

Chapter 1 includes analysis of the overall legal framework of the MEIP. Chapter 2 analyses the legal framework of airport charges, in particular the Airport Charges Directive. Chapter 3 focuses on airport business models and related airport charges. Chapter 4 provides an extensive analysis of the MEO methodology including the principles of *ex ante* assessment, incremental profitability (entireness of a measure, cost recovery, rate of return on the investment and long term perspective) and equal access to airport infrastructure.

The Master's Thesis substantiates that differentiated pricing policies of the EU airports may not always be commercially justified to comply with the MEO test. This especially holds true for regional airports with annual traffic less than 3 million according to definition of the General Block Exemption Regulation. The economic behaviour of regional airports can be explained by the need to raise traffic volume in the environment of limited choice of opportunities. Besides, many regional airports receive operating and investment aid, therefore marginal contribution of an airline at issue to the profitability of an airport is of less importance.

The *ex ante* assessment of profitability of commercial transactions made by airport managing bodies at the same time have to comply with competition and sectoral law. In this regard, the Airport Charges Directive provides solid grounds for determination and application of airport charges based on the principles of non-discrimination, compulsory consultation, transparency, involvement in development plans, service standards and price differentiation.

It is likely that the number of State aid cases could decrease if the Airport Charges Directive were applied to certain categories of regional airports.

*Key terms: State aid, airport operations, price differentiation, market economy investor principle, market economy operator test.*

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## List of abbreviations and terms

Abbreviation or term	Meaning
Airport	Any land area specifically adapted for the landing, taking-off and manoeuvring of aircraft, including the ancillary installations which these operations may involve for the requirements for the requirements of aircraft traffic and services, including the installations needed to assist commercial air services. <sup>1</sup>
Airport charge	A levy collected for the benefit of the airport managing body and paid by the airport users for the use of facilities and services, which are exclusively provided by the airport managing body and which are related to landing, take-off, lighting and parking of aircraft, and processing of passengers and freight <sup>2</sup>
Airport Charges Directive	Directive 2009/12/EC of the European Parliament and of the Council of 11 March 2009 on airport charges
Airport managing body	A body which, in conjunction with other activities or not as the case may be, has as its objective under national laws, regulations or contracts the administration and management of the airport or airport network infrastructures and the coordination and control of the activities of the different operators present in the airports or airport network concerned
Airport user	Any natural or legal person responsible for the carriage of passengers, mail and/or freight by air to or from the airport concerned <sup>3</sup>
Aviation Guidelines	The Communication from the Commission – Guidelines on State aid to airports and airlines of 4 April 2014
CAPM	Capital Asset Pricing Model
CJEU	The Court of Justice of the European Union which includes the General Court and the European Court of Justice
Commission	European Commission
Commission Notice on the Notion of State Aid	The Commission Notice on the Notion of State aid as referred to in Article 107(1) of the Treaty on the Functioning of the European Union (2016/C 262/01) of 19 July 2016
DG COMP	Directorate-General for Competition of the European Commission
EU	European Union

<sup>1</sup> Directive 2009/12/EC of the European Parliament and of the Council of 11 March 2009 on airport charges, OJ L 70, 14.03.2009, p.13.

<sup>2</sup> Ibid, p.13

<sup>3</sup> Ibid, p.13.

<b>Abbreviation or term</b>	<b>Meaning</b>
EUR	Euro, the Official Currency of the European Union
EUROCONTROL	The European Organisation for the Safety of Air Navigation
IRR	Internal Rate of Return
MEIP	Market Economy Investor Principle
MEO	Market Economy Operator
NPV	Net Present Value, the Difference between the Positive and Negative Cash Flows over the Lifetime of the Investment, Discounted to their Current Value using the Cost of Capital <sup>4</sup>
ROE	Return on Equity
TFEU	Treaty on the Functioning of the European Union
WACC	Weighted Average Cost of Capital

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<sup>4</sup> Communication from the Commission – Guidelines on State aid to airports and airlines, OJ C 99, 04.04.2014, p.9.

## Introduction

Aviation sector is one of the fastest growing sectors of economy which contributes 2.1% to the gross domestic product of the European Union (EU) and provides close to 5 million jobs<sup>5</sup>. This raises pressure on the airports of the EU which have to accommodate ever increasing traffic volumes. According to EUROCONTROL, the average annual growth rate of Instrumental Flight Rules' movements will be 1.8% until 2035<sup>6</sup>.

According to the Aviation Strategy for Europe, of one key priorities of the European Commission (Commission) is boosting the efficiency of airport services to increase the competitiveness of the EU aviation sector and the service quality for passengers<sup>7</sup>.

The aviation sector is one of the most liberalised markets in the EU. There are no cross-border restrictions on delivery of air transport services between Member States and its airports. All EU airlines can operate any route within the Member States. Due to the open market, the air transport sector has become very competitive and volatile with regard to profit margins. In response to growing competition and business uncertainty, there is room for unfair competition in order to cut airlines' costs.

In the common market of the EU, the market should determine the level of airport charges. However, this is not always the case due to division of market power between airports and users of the airports' infrastructure (airlines). Due to their catchment area many airports are natural monopolies and citizens have limited choice to select another air transport hub to provide air transport connectivity.

Application of airport charges to commercial civil aviation airports are governed by Directive 2009/12/EC of the European Parliament and of the Council of 11 March 2009 on airport charges (Airport Charges Directive). Member States transposed the Airport Charges Directive in national law during 2011 – 2014. The Commission has established the expert group called Thessaloniki Forum of Airport Charges Regulators to help the Commission determining the optimal regulatory approach of airport charges<sup>8</sup>.

Airports provide different pricing strategies to airports. While price discrimination is considered as normal practice according to State aid case law, the application of this principle has raised complaints from competing airlines regarding the pricing policies applied to their competitors<sup>9</sup>. The concern of the industry is whether lower airport charges are indirect subsidies from airports to airlines and if such incentives may distort competition.

Article 345 of the Treaty on the Functioning of the European Union (TFEU) is neutral with regard to ownership of business and it allows Member States to run a mixed economy (e.g., an economy of both private and public companies). While air carriers are mostly privately owned and face competition also from non-EU carriers, the majority of EU airports is still

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<sup>5</sup> European Commission, Transport. Transport modes. Air.

<sup>6</sup> EUROCONTROL, Challenges of Growth 2013. Task 4: European Air Traffic in 2035. 2013, p. 4.

<sup>7</sup> European Commission, An Aviation Strategy for Europe. 2015, p. 7.

<sup>8</sup> European Commission. Register of Commission Expert Groups. Thessaloniki Forum of Airport Charges Regulators.

<sup>9</sup> For example, see Commission Decision (EU) 2015/506 of 20 February 2014 on the measures taken by Germany with regard to Flughafen Berlin-Schönefeld GmbH and various airlines – SA.15376 (C 27/07, ex NN 29/07), OJ L 89, 01.04.2015.

publicly owned. According to the ACI Europe, out of 355 commercial airports of the EU-28, 53% were fully publicly owned airports and 30% airports had mixed ownership in 2016<sup>10</sup>.

According to State aid case law, airports are undertakings engaged in an economic activity and therefore subject to State aid law. One of criteria for assessment of existence of State aid is the economic advantage of a planned measure (economic activity) to potential recipient of aid (airport user). The legal framework of State aid law is provided in Chapter 1 of the Master's Thesis.

One of the State aid control tools introduced by the Commission to analyse the existence of economic advantage of a measure is the market economy operator (MEO) test. The MEO test is an application of the so called Market Economy Operator Principle or Market Economy Investor Principle (MEIP) to a planned economic measure of an undertaking. The MEIP has several sub-types (derivatives) depending on economic area of analysis (market economy lender principle, market economy creditor principle, market economy guarantor principle, market economy vendor principle etc.).

The subject of the Master's Thesis is application of the MEIP to assess the existence of economic advantage to airport users in case of differentiation of airport charges. The scope of the Master's Thesis excludes analysis of airport charges for terminal air navigation charges, ground handling services and assistance to disabled passengers and passengers with reduced mobility which are governed by different legal framework to that of the Airport Charges Directive.

The hypothesis of this Master's Thesis is that *differentiated pricing policies of the EU airports are not always commercially justified to comply with the MEO test*. The rationale behind this hypothesis is that price differentiation of airport charges as a standard business practice applied by airport management bodies should be non-discriminatory to all airport users. Besides, allocation of the airports' fixed and variable costs between the existing and new airport users have to be considered to assess the incremental profitability of airports' new agreements with airport users.

In order to verify the proposed hypothesis, the structure of the Master's Thesis is as follows:

- a) Analysis of the existing legal framework of State aid law with regard to application of the MEIP to assess an economic advantage of a measure.
- b) Analysis of the existing legal framework with regard to airport charges.
- c) Analysis of airports' business models, infrastructure development rationale and cost structure.
- d) Analysis of the Court of Justice of the European Union's (CJEU) and the Commission's case law in the area of application of the MEIP to airports.
- e) Conclusions with regard to approval or rejection of the aforementioned hypothesis.

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<sup>10</sup> Airports Council International Europe, *The Ownership of Europe's Airports*. 2016, p. 4.

# 1. The legal framework of the Market Economy Investor Principle

## 1.1. Features of existence of State aid

According to Article 107(1) TFEU,

( ... ) any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings ( ... ) shall, in so far as it affects trade between Member States, be incompatible with the internal market.<sup>11</sup>

Member States are not allowed to grant State aid without the approval of the Commission except the aid measures exempt from notification obligation set out in EU secondary law.

Article 108 (3) TFEU provides:

The Commission shall be informed, in sufficient time to enable it to submit its comments, of any plans to grant or alter aid. If it considers that any such plan is not compatible with the internal market having regard to Article 107, I shall without delay initiate the procedure provided for in paragraph 2. The Member State concerned shall not put its proposed measures into effect until this procedure has resulted in a final decision.<sup>12</sup>

The criteria of existence of State aid are further analysed in the secondary law of the EU. The main legal reference of State aid is the Commission Notice on the Notion of State aid as referred to in Article 107(1) of the Treaty on the Functioning of the European Union (2016/C 262/01) of 19 July 2016 (Commission Notice on the Notion of State Aid). The State aid in aviation sector is further set out in the Communication from the Commission – Guidelines on State aid to airports and airlines (2014/C 99/03) of 4 April 2014 (Aviation Guidelines).

The Commission Notice on the Notion of State Aid provides clarification of the concept of State aid according to interpretation of the CJEU.

In order for an aid to qualify as State aid granted to an undertaking, a measure need to fulfil four cumulative criteria (features) listed in Article 107(1) TFEU:

- a) An intervention by the State or through State resources.
- b) The intervention gives the recipient an advantage on a selective basis.
- c) Competition has been or may be distorted.
- d) The intervention is likely to affect trade between Member States.<sup>13</sup>

An economic advantage is any economic benefit (e.g., granting of economic benefits and relief of economic costs) which an undertaking would not have obtained under normal market conditions. The concept of economic advantage is defined in several judgements of the CJEU, for example, in Case C-39/94 *SFEI and Others*:

Accordingly, in order to determine whether a State measure constitutes aid, it is necessary to establish whether the recipient undertaking receives an economic advantage which it would have obtained under normal market conditions.<sup>14</sup>

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<sup>11</sup> Treaty on the Functioning of the European Union (Consolidated version 2012), OJ C 326, 26.10.2012, p. 91.

<sup>12</sup> *Idid* p. 91.

<sup>13</sup> Website of the European Commission. Competition. State aid.

<sup>14</sup> Judgement in *SFEI and Others*, C-39/94, EU:C:1996:285, para. 60.



## 1.2. Notion of undertaking and economic activity of an airport

Point 6 of the Commission Notice on the Notion of State aid provides: “The State aid rules only apply where the beneficiary of a measure is an “undertaking.””<sup>15</sup>

According to interpretation of the CJEU,

( ... ) in the context of competition law, first that the concept of an undertaking encompasses every entity engaged in an economic activity, regardless of the legal status of the entity and the way in which it is financed ( ... ).<sup>16</sup>

It follows from the aforementioned quote that undertaking is an entity (public or private) which at the same time carries out economic activities.

Consequently, airports of Member States, regardless of the form of ownership, are undertakings in the meaning of TFEU and are therefore subject to State aid rules. Article 345 TFEU provides: “The Treaties shall in no way prejudice the rules in Member States governing the system of property ownership.”<sup>17</sup>

The CJEU in Case C-118/85 *Commission v Italy* held that

( ... ) the State may act either by exercising public powers or by carrying on economic activities of an industrial or commercial nature by offering goods and services on the market. In order to make such a distinction, it is therefore necessary, in each case, to consider the activities exercised by the State and to determine the category to which those activities belong.”<sup>18</sup>

For many years public authorities provided public financing to cover investment and variable costs of airport and such financing did not constitute State aid according to State aid law. According to Oswell, Metaxas and Vahida, it is nearly impossible to find any regional airport in Europe which has not received investment or operating aid.<sup>19</sup> The situation changed in 2000 when the CJEU held in Case T-128/98 *Aéroports de Paris v Commission* that operation of airport constituted an economic activity.<sup>20</sup>

In the appeal case before the General Court T-128/98, the CJEU ruled in Case C-82/01 P *Aéroports de Paris v Commission* that the operation of an airport was an economic activity providing paid services on a market: “( ... ) the provision of airport facilities to airlines and the various service providers, in return for a fee ( ... ) constitutes an economic activity.”<sup>21</sup>

In the meaning of the Aviation Guidelines, “airport” means an entity or group of entities performing the economic activity of providing airport services to airlines.”<sup>22</sup> The Airport Charges Directive provides additional explanation of the term “airport” (see definition in the List of Abbreviations and Terms above).

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<sup>15</sup> Commission Notice on the notion of State aid as referred to in Article 107(1) of the Treaty on the Functioning of the European Union, OJ C 262, 19.07.2016, p. 3.

<sup>16</sup> Judgement in *Höfner and Elser v Macroton*, C-41/90, EU:C:1991:161, para. 21.

<sup>17</sup> Treaty on the Functioning of the European Union (Consolidated version 2012), OJ C 326, 26.10.2012, p.194.

<sup>18</sup> Judgement in *Commission v Italy*, C-118/85, EU:C:1987:283, para. 7.

<sup>19</sup> Oswell, Dennis, Metaxas, George, and Vahida, Esfandiar. “CFI Judgement in the Charleroi Case T-196/04,” in *Milestones in State Aid Case Law. EStAL’s First 15 Years in Perspective*, ed. Buts, Caroline et.al. (Berlin: The Lexxion Publisher, 2017), p. 244.

<sup>20</sup> Judgement in *Aéroports de Paris v Commission*, T-128/98, EU:T:2000:290, paras. 108-124.

<sup>21</sup> Judgement in *Aéroports de Paris v Commission*, C-82/01 P, EU:C:2002:617, para. 78.

<sup>22</sup> Supra 4, p. 8.

## 1.3. Methodology of the Market Economy Investor Principle

### 1.3.1. Evolution of the Market Economy Investor Principle

The main challenge of application of the MEIP is that it is not directly mentioned in TFEU – the MEIP is an interpretation of applicability and application of Article 107(1) TFEU. The MEIP has been applied in EU State aid law for around thirty years. For the first time the concept of MEIP was introduced in 1984 when the Commission published the Commission’s position on Public Authorities’ Holdings in Company Capital: “( ... ) there is State aid where fresh capital is contributed in circumstances that would not be acceptable to a private investor operating under normal market economy conditions.”<sup>23</sup> The CJEU have further developed the concept of the MEIP in several cases of public investment which involves capital injection.

According to the Aviation Guidelines, in certain circumstances a planned State aid measure has to be notified to the Commission before the adoption of a planned measure. If a planned economic activity is assumed to be economically viable, an efficient applicability of the MEIP could solve the problem because in case of fulfilment of the MEO test a planned measure (economic activity) does not constitute State aid and does not have to be notified to the Commission.

The Competition Policy Newsletter of the Commission has devoted several articles over the last 15 years on the subject of the MEIP. The Commission services (DG COMP) acknowledge the usefulness of the MEIP because TFEU does not allow differentiation between public and private property ownership<sup>24</sup>. The absence of economic advantage is met if it is proved that an undertaking could have obtained the same financing in the financial or capital market (e.g. without financing from public authorities). The Commission services refer to so called “counterfactual analysis” of economic advantage by analysing the position of an undertaking in situation with and without the planned measure.

No standardised methodology exists with regard to the MEIP. The methodology is applied on a case by case basis following the existing case law of the CJEU and State aid decisions of the Commission. The DG REGIO Guide to Cost-Benefit Analysis<sup>25</sup> is sometimes used in State aid cases but, to the author’s knowledge, not referred to airport cases. Besides, the DG REGIO Guide to Cost-Benefit Analysis is applied only to State aid measures at the project level and not at the company level (for example, in cases of capital contribution or waiving of dividends where a subject of analysis is the company).

The CJEU held in Joined Cases C-83/01 P, C-93/01 P and C-94/01 P *Chronopost v UFEF* that in situations where it was not possible to compare an economic activity of an undertaking to a private undertaking in particular sector of national economy, hypothetical normal market conditions had to be assessed.<sup>26</sup> This includes objective and verifiable elements which at the same time are available for assessment. “The objective and verifiable elements” can constitute costs of an undertaking at issue. There is no State aid if price of the service covers such costs.

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<sup>23</sup> Bulletin of the European Communities No 9 1984. Volume 17. Part Three Documentation. 5. Public Authorities’ Holdings in Company Capital, Point 3.3., p. 94.

<sup>24</sup> Slocock B., The market economy investor principle. European Commission. Competition Policy Newsletter. Number 2 – June 2002, p.23.

<sup>25</sup> See, for example, European Commission. Guide to Cost-Benefit Analysis of Investment Projects. Economic Appraisal Tool for Cohesion Policy 2014-2020. December 2014.

<sup>26</sup> Judgement in *Chronopost v Ufex and Others*, Joined Cases C-83/01 P, C-93/01 P and C-94/01 P, EU:C:2003:388, paras. 38-40.

This case law have led to application of cost-benefit type of analysis in State aid cases of the Commission.

### 1.3.2. Types of the Market Economy Operator test

The applicability of the MEIP can be classified according to its economic nature whether a particular measure is a real life example or an assumption (a hypothetical model characterizing the possible behaviour of a private investor). The first aforementioned cases are referred to as *pari-passu* transactions (cases of concomitance of public and private undertakings) and open procurement procedures. The second cases are benchmarking and cost-benefit analysis (calculation of profitability of a planned measure by applying financial performance indicators – internal rate of return (IRR) and net present value (NPV)). The MEO test in fact is a method of cost-benefit analysis (one of economic appraisal tools to assess business decisions) although the term “MEO test” is preferred to the “cost-benefit analysis” in State aid case law.

The Aviation Guidelines does not use the term of cost-benefit analysis, however, it is mentioned in State aid case law. For example, Recitals 108, 111 and 115 of State aid case C12/08 (ex NN 74/07) - Slovakia – Agreement between Bratislava Airport and Ryanair (State aid case C 12/08 of Bratislava Airport) includes a reference to the “cost-benefit analysis” in the meaning as a quantitative exercise of the MEO test. Besides the cost-benefit analysis, the Commission also assessed qualitative aspects of the measure like diversification of airlines operation from the airport, better allocation of resources and reduction in overcapacity.<sup>27</sup>

The problem of applicability of the MEIP is that there is very seldom available information on an “equivalent market economy investor”. Motivation of market investors is very different and depends on their preferences with regard to the mix of risk and return on investment. Benchmarking thus refers to assessment of measures where specific market data (“market examples”) are not available.

Points 59 and 61 of the Aviation Guidelines provide that the Commission considers an *ex ante* incremental profitability analysis the most appropriate method of the MEO test as far as it refers to agreements among airports and individual airlines. The Commission is not aware that a true benchmark can be established to assess the market prices of services provided by airports.<sup>28</sup>

According to the Commission, benchmarking is not considered as a feasible analysis method because the cost and revenue structure of the EU airports is widely different. It depends on many factors like the number of airport users, airport capacity, technical condition of infrastructure, volume of debt service, regulatory framework of particular Member State and other factors. Benchmarking means finding a sufficient number of airports with comparable services under normal market conditions which is difficult to achieve in reality.

Besides, many airports have received public funding in the past which is not always reflected in aviation charges. This also refers to Member States before joining the EU when those countries did not have to follow EU law including that of State aid.

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<sup>27</sup> Commission Decision of 27 January 2010 on State aid C 12/08 (ex NN 74/07) – Slovakia – Agreement between Bratislava Airport and Ryanair, OJ L 27, 01.02.2011.

<sup>28</sup> Supra 4.

### **1.3.3. Ex ante assessment of profitability of a private investor**

According to the Commission Notice on the Notion of State Aid, the principle of *ex ante* assessment is set forth in Case C-124/10 P *Commission v EDF* and Case C-482/99 *France v Commission*.<sup>29</sup> The existence of State aid has to be examined on *ex ante* basis considering the strategy (business plan) and financial prospects of a measure and concerning the available information during the period of an *ex ante* evaluation. *Ex post* evaluation is not an accepted practice and is not enough to justify the profitability of a private investor. It means that the MEO test has to be applied before the planned measure. A prudent market economy investor should follow a long-term (more than ten years) prospects of profitability and short-term profitability is not mandatory. *Ex ante* assessments have to be carried out by experienced and independent experts.

The principle of *ex ante* assessment is further explained in the Aviation Guidelines and applied in the Commission's case law. According the Aviation Guidelines, the Commission considers *ex ante* incremental profitability analysis as the most relevant approach to assess the agreements concluded among airport managing bodies (airports) and airport users (airlines).

### **1.3.4. Economic versus non-economic activities of the State**

For the purpose of the MEO test only economic activities of the State have to be considered disregarding the public remit functions. Public policy consideration of the State should be excluded.<sup>30</sup> This principle is ruled in several cases of the CJEU, for example, Case C-124/10 P *Commission v EDF*.

It is important to note that activities carried out by the State in the exercise of its official powers is not considered as State aid. As refers to airports, activities of a non-economic nature at airports are such as air traffic control, police, customs, firefighting, security measures against acts of unlawful interference and others.<sup>31</sup>

Consequently, non-economic activities have to be separated from economic activities and excluded from the MEO test. At the same time the cross-subsidisation of economic activities from revenues of non-economic activities has to be avoided and may constitute State aid.

### **1.3.5. Financial performance indicators of the Market Economy Operator test**

Following the methodology of a cost-benefit analysis, the time horizon of the MEO test is the life cycle of a planned measure (for example, a service agreement between an airport and an airline). It can be short, medium or long term and future benefits can offset losses (investment or operating costs) during the first years of operation. The MEO test is carried out on cash basis where the flow of revenues and costs is discounted at the first year of a planned measure.

In this regard, the outcome of the MEO test is values of two financial performance (profitability) indicators: NPV and IRR where NPV stands for the discounted sum of operating revenues subtracted by the discounted sum of operating and investment costs, and IRR is the discount rate that produces a zero NPV. The MEO test is fulfilled if NPV exceeds

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<sup>29</sup> Supra 15, point 178.

<sup>30</sup> Supra 15, point 77.

<sup>31</sup> Supra 4, point 35.

zero currency units (EUR) and, in other words, IRR exceeds the discount rate which is used as the opportunity cost of capital. If NPV is higher than zero it means that IRR exceeds the required rate of return (opportunity cost of capital).

A proxy of the opportunity cost of capital is so called weighted average cost of capital (WACC) which considers to traditional sources of airports' financing: debt and equity financing. Both the Commission Notice on the Notion of State Aid and the Aviation Guidelines do not include an exact explanation of the WACC and as well the capital asset pricing model (CAPM). However, this method is used in State aid cases.<sup>32</sup>

It should be noted that Point 102 of the Commission Notice on the Notion of State Aid provides an important attribute of the cost of capital.<sup>33</sup> It says that an expected return on the planned measure must be compared to that of the normal expected market return including the risk of investment and specific features of the sector (in particular case the airports' sector). If the normal return is not expected (e.g., IRR equal or above the opportunity cost of capital), then the planned measure is not carried out on market terms.

The Thessaloniki Forum of Airport Charges Regulators has released the guidelines on calculation of the WACC for airport managing bodies including the CAPM.<sup>34</sup> It is an important concept because the cost of capital is part of airport charges.

WACC = equity ratio \* cost of equity + debt ratio \* cost of debt \* (1 – tax rate of the corporate income tax).

CAPM =  $r_i = r_f + (r_m - r_f) * \beta_i$ , where

$r_i$  - cost of capital;

$r_f$  - return of risk-free investments;

$r_m$  - capital market risk premium;

$\beta_i$  - beta factor (coefficient);

$i$  - iteration sequence number.

The cost of debt is calculated based on average cost of capital of an undertaking or using the formula in accordance with the Communication from the Commission on the revision of the method for setting the reference and discount rates of 19 January 2008 (Commission Communication for Reference and Discount Rates).<sup>35</sup> In such a case the cost of debt is calculated as follows:

Cost of debt = calculation basis (a risk free or base rate) + margin (a risk premium based on the rating of the undertaking and the level of collateral).<sup>36</sup> The Commission recommends adding 100 basis points of risk premium to the base rate for companies of credit history or a rating based on a balance sheet approach. The reference rate which includes the base rate and a fixed margin of 100 basis points can be used as a discount rate for calculation of NPV in

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<sup>32</sup> See for example, European Commission. State Aid SA.41342 (2016/N) – Germany. Financing of Berlin Brandenburg Airport, C (2016) 4948, 03.08.2016.

<sup>33</sup> Supra 15, p.24.

<sup>34</sup> European Commission. Thessaloniki Forum of Airport Charges Regulators. Recommendations for the Setting and the Estimation of the WACC of Airport Managing Bodies. December 2016.

<sup>35</sup> Supra 4.

<sup>36</sup> Communication from the Commission on the revision of the method for setting reference and discount rates, OJ C 14, 19.01.2008, p.8.

State aid cases, where appropriate. The base rates are published on the Commission's website on regular basis.

The cost of capital (equity) is calculated using the CAPM.

For the risk-free investment rate, the long-term bond issue rate of the government of the Member State in which the airport is situated is used when such government bonds of a Member State are considered to be risk-free.<sup>37</sup>

The capital market risk premium stands for the average value of the return on industry capital – return on equity.

Beta coefficient is determined in accordance with the public information for the relevant industry and characterising correlation of share prices of companies in this industry with changes in the overall stock market. Beta coefficients are taken from the stock exchange information for the companies whose shares are traded on the exchange. Beta coefficients show the market risk - how risky are assets of particular company compared to the industry average.  $\beta_i = 0$  stands for risk-free investment,  $\beta_i = < 1$  represents less risk than the market portfolio (a sample of airports),  $\beta_i = > 1$  represents larger risk than the market portfolio,  $\beta_i = 1$  represents the same risk as the market portfolio.

At the final stage of analysis the financial performance indicators are subject to sensitivity analysis to determine how changes in model assumptions (independent variables like traffic volume, investment costs, operating costs, start-up of operations, discount rate etc.) affect the financial performance indicators (dependent variables). The sensitivity analysis can also include a scenario analysis of usually three scenarios: real (baseline) case, optimistic case and pessimistic case.

In conclusion, the MEO test includes the following attributes to derive the financial performance indicators of the measure:

- a) Incremental approach – counterfactual analysis where situation “with measure” is compared to situation “without measure”.
- b) Quantification approach – all costs and revenues are expressed in monetary terms.
- c) Cash flow approach – analysis is performed on cash basis compared to the profit or loss statement approach.
- d) Present value approach – discounting of cash flow during the measure's life cycle.
- e) Medium to long-term perspective – where applicable, the MEO test has to be carried out during the life cycle of legal obligations (duration of agreement) or useful life of assets.
- f) Current (nominal) versus real (constant) prices – a consistency in applied price level has to be preserved. Usually the MEO test is carried out in nominal prices to capture the macroeconomic impacts (inflation).
- g) Profitability approach – the MEO test disregards economic benefits associated with implementation of the measure and focuses only on business profitability of a private investor.
- h) Discount factor (IRR) – the applied discount factor for calculation of NPV measures the expected profit margin of a private investor and reflects the opportunity cost of capital

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<sup>37</sup> Ibid 36.

(expressed as WACC). Such cost is usually higher than risk-free investment (for example, in government securities).

- i) Sensitivity analysis – the impact of changes in variables of the measure on financial performance indicators have to be tested.

### **1.3.6. Judicial review of the application of the Market Economy Investor Principle**

One of the baseline court cases with regard to application and applicability of the MEIP is Case T-196/04 *Ryanair v Commission* (Charleroi Airport judgement). After the Charleroi Judgement the role of financial analysis, in particular the MEO test, increased in State aid case law. According to the CJEU, the application of the MEO test involves a complex economic appraisal and the court is even not entitled to substitute its own MEO test for that of the Commission.

On the contrary, the Commission applies the MEIP in State aid cases where it has opened a formal or preliminary investigation procedure under Article 108 (2) TFEU against a concerned Member State in case of potential unlawful aid.

See also Case C-56/93 *Belgium v Commission* where the CJEU argued that the MEO test was the economic analysis outside the CJEU's expertise.

## **2. The legal framework of airport charges**

The Airport Charges Directive applies to the EU airports with annual traffic over than 5 million passenger movements and to the airport with the highest number of annual passenger movements in each Member State. Member States were supposed to transpose the Airport Charges Directive in national law by 15 March 2011.

The Airport Charges Directive provides for the principle of non-discrimination:

Member States shall ensure that airport charges do not discriminate among airport users, in accordance with Community law. This does not prevent the modulation of airport charges for issues of public and general interest, including environmental issues. The criteria used for such a modulation shall be relevant, objective and transparent.<sup>38</sup>

It follows from the definition above that airport charges can be modulated and the criteria of modulation will be applied equally to all airport users. However, the meaning of “modulation of airport charges for issues of public and general interest” is not further explained in the Airport Charges Directive.

Airport managing bodies are not allowed to set airport charges arbitrarily. Instead, they have to consult with airport users and such consultation have to be regular and *compulsory* [emphasis added]. In case of disagreement both parties can seek the intervention of an independent supervisory authority which is nominated according to national law (in most cases such intermediaries are civil aviation authorities of Member States). Article 6 of the Airport Charges Directive says:

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<sup>38</sup> Directive 2009/12/EC of the European Parliament and of the Council of 11 March 2009 on airport charges, OJ L 70, 14.03.2009, p.13.

Member States shall ensure that, wherever possible, changes to the system or the level of airport charges are made in agreement between the airport managing body and the airport users.<sup>39</sup>

According to Article 7 of the Airport Charges Directive, airport managing bodies have to be transparent in their exposure of methodology, costs and service level attributed to calculation of airport charges as well as traffic, airport charges and investment forecasts, operation revenues, infrastructure and equipment utilization, financing from public authorities and other relevant information.<sup>40</sup>

As regards the construction of a new infrastructure, Article 8 of the Airport Charges Directive rules that the airport managing body has to consult with airport users beforehand<sup>41</sup>. The Airport Charges Directive does not impose categories of new infrastructure, for example, universal or dedicated infrastructure. Therefore, in author's opinion, the airport managing body has to consult airport users before the development plans of any type of new infrastructure.

Article 9 of the Airport Charges Directive provides the legal framework with regard to the quality of service at the airport. The agreed quality standards among the airport managing body and airport users should be managed by service level agreements. In this regard it is important to note that such service level agreements provide a balance between the level of service and airport charges to be paid for this service.

Article 10 of the Airport Charges Directive allows differentiation of airport infrastructure and services and respectively airport charges subject to quality and scope of the service.

( ... ) The level of airport charges may be differentiated according to the quality and scope of such services and their costs or any other objective and transparent justification. Without prejudice to Article 3, airport managing bodies shall remain free to set any such differentiated airport charges.<sup>42</sup>

Besides, in case of tailored or dedicated infrastructure, any airport user has rights to use such an infrastructure. If more airport users want to have access to tailored or dedicated infrastructure, the airport managing body has to provide such infrastructure and services on relevant, objective, transparent and non-discriminatory basis.

It is important to note that, in author's opinion, differentiation of airport charges are only allowed subject to differentiation of airport services and that such differentiation must remain non-discriminatory.

In summary, the Airport Charges Directive includes the following main principles with regard to applicability and application of airport charges:

- a) Non-discrimination of airport charges among airport users.
- b) Approval of airport charges and service standards after compulsory consultation of airport users.
- c) Transparency of airport charges.
- d) Public consultation with airport users with regard to development plans or new infrastructure.

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<sup>39</sup> Ibid, p. 15.

<sup>40</sup> Ibid, p. 14.

<sup>41</sup> Ibid, p. 15.

<sup>42</sup> Ibid, p. 15.



- e) Service level agreements have to be signed between the airport managing body and airport users which determine the quality of infrastructure and service in return of paid airport charges.
- f) Development of tailored or dedicated infrastructure and services subject to price differentiation under condition that such infrastructure and services are available to all potential airport users on relevant, objective, transparent and non-discriminatory basis.

Although the Commission adopted the Airport Charges Directive already five year ago, a public debate has been continuing with regard to enforcement of the aforementioned regulation. The Airlines for Europe, the Europe's largest airline association, is of opinion that the Airport Charges Directive is implemented fragmentarily, inefficiently and inconsistently between Member States. They argue that airport charges have increased substantially while airline fares have decreased during the ten years' time period (2006-2016).<sup>43</sup> The Airlines for Europe considers that monopoly power of large EU airports have to be eliminated and the organization even opts for an EU Regulation on airport charges.

Airlines and airports are on different sides of the border. It is quite logical that the ACI Europe, the Europe's largest airport association, has different opinion to that of the Airlines for Europe. The ACI Europe argues that due to development of new airline business models the market power has shifted from airports to airlines. To the contrary of the Airlines for Europe, the ACI Europe is of the opinion that airport regulation is not needed because they cannot move to another market location while airlines have a variety of choice to fly from. As a consequence, airports are motivated to work hard in order to retain existing traffic and attract new traffic.<sup>44</sup>

The position of the Commission is rather in favour of airports. Regardless of the initiation of several infringement procedures, the Commission stated the following: "At his early stage, the Commission finds that a number of the main objectives of the Directive have already been achieved."<sup>45</sup>

Acknowledging the complexity of the issue, the Commission established the Thessaloniki Forum of Airport Charges Regulators in 2014. This Expert Group has published several reports with regard to efficient enforcement of the Airport Charges Directive.

The main focus of the Master's Thesis is on the first principle of the application of airports charges according to the Airport Charges directive which is non-discrimination of airport charges among airport users - airlines.

### **3. Airport business models and airport charges**

For the purposes of the Master's Thesis two airport business models are distinguished: major (hub) airports and regional airports. Business models of airports are interrelated to the ones of airlines. Low cost carriers prefer using regional airports while full service carriers operate

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<sup>43</sup> Airlines for Europe, Press Release "Revised Airport Regulation will Benefit European Consumers." 6 March 2018. Available on: <https://a4e.eu/wp-content/uploads/2018/03/AGM-2018-Airport-charges-press-release-final.pdf>. Accessed 22 April 2019.

<sup>44</sup> Airports Council International Europe, Press Release "Airports react to EC Report on Airport Charges Directive." 19 May 2014.

<sup>45</sup> European Commission, Report from the Commission to the European Parliament and the Council on the Application of the Airport Charges Directive (COM (2014) 278). 19 May 2014, p.4.

mainly from air hubs. During the last decade the distinction between low costs carriers and full service carriers became blurred as airlines tried reaping benefits from both consumer segments (for example, emergence of hybrid carriers). Airports have responded as well to market trends and some of them have developed “regional air hubs” like in the case of Riga International Airport.

There is no definition of hub or regional airports in EU law except the General Block Exemption Regulation<sup>46</sup> which provides that “regional airport” is an airport of annual traffic below 3 million passengers.

Besides direct (point-to-point) traffic, hub (hub-and-spoke) airports concentrate traffic by airlines to deliver transfer and transit passengers to their final destinations. Disregarding direct traffic, other airports are feeder airports to hub airports.

The Aviation Guidelines provide classification of airports according the number of passengers served per annum. This classification is used to calculate the maximum intensity of investment operating aid and start-up aid.

The ACI Europe uses different approach to definition of airports. The regional airport is an airport which serves point-to-point destinations on short to medium term routes. To its view, regional airports is the backbone of the European common market providing connectivity of both businesses and people. In 2015, there were 466 regional airports in the EU-28. 419 (90%) of them had passenger turnover less than five million, 314 (67%) less than one million and 202 (43%) less than 200 thousand per year.<sup>47</sup> 79 airports were subject to the Airport Charges Directive, including 48 (61%) regional airports, in 2015.

Five million passengers is the threshold of the need for State intervention with regard to investment aid according to the Aviation Guidelines. 200 thousand passengers is the ceiling provided in the General Block Exemption Regulation allowing simplified rules for investment aid as well as operating aid in small airports.

Regional airports have the following characteristics:

- a) Traffic volatility including seasonality and limited possibilities of traffic diversification.
- b) Dominant market power of airlines. Usually one or two airlines account for more than 50% of total traffic. Majority of traffic is provided by low cost carriers.
- c) Strong bargaining power of airlines which result in pushing down of aeronautical charges.
- d) Risk of overcapacity or under capacity of airport’s infrastructure which entails difficulty of long-term strategic planning.
- e) Total costs per passenger are higher compared to hub airports due to limited economies of scale. Smaller customer base and commercial revenue possibilities compared to hub airports.

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<sup>46</sup> Point 153 of the Commission Regulation (EU) 2017/1084 of 14 June 2017 amending Regulation (EU) No 651/2014 as regards aid for port and airport infrastructure, notification thresholds for aid for culture and heritage conservation and for aid for sport and multifunctional recreational infrastructures, and regional operating aid schemes for outermost regions and amending Regulation (EU) No 702/2014 as regards the calculation of eligible costs, OJ L 156, 20.06.2017.

<sup>47</sup> Airports Council International Europe, European Regional Airports. Connecting People, Places and Products. 2017.

The market power and determination of airport charges varies according to the size and business model of an airport. For the EU airports the average share of aeronautical (aviation) revenues was 63% compared to 37% of non-aeronautical (non-aviation) revenues in 2014.<sup>48</sup> Compared to aviation revenues (aircraft take-off and landing fees, passenger security fees, centralised infrastructure fees, revenues from ground handling services etc.), non-aviation revenues (lease of fixed assets, utilities, business passengers, advertising services, concessions, car parking etc.) has become a very important revenue source of today's airport business. Both capital and operating costs are included in the cost basis for airport charges, and such cost basis can be offset by non-aviation revenues. Many airports use non-aeronautical revenues to finance aeronautical costs (so called "single-till model" of airport charges). Majority of the EU airport operate under the single-till system.

Due to smaller number of passengers compared to large airports (air hubs) and high fixed costs it is difficult for regional airports to reach economies of scale. Besides, it is cumbersome to attract funding for financing of capital expenditures, therefore regional airports are dependent on public funding (including the European structural and investment funds). For regional airports it is important to develop the route network and increase the portfolio of serving airlines.

On average, capital costs of European airports, including the EU airports, amounted to 34% of total costs compared to 66% of operating costs in 2014.<sup>49</sup> The capital costs include debt service costs and depreciation of fixed assets. They are airports' fixed costs because they remain constant regardless of traffic volume.

At the same time a big part of operating costs are as well fixed costs. Airports have to provide equipment and staff 24 hours per day while aircraft and passengers are serviced mainly during peak hours which mostly occurs two or three times a day (in mornings, mid-days and evenings). This is because by national law airports have to service any kind of aircraft including general aviation, military, border guards, emergency health care and other type of traffic. Besides, regional (non-hub) airports are affected by traffic volatility (for example, leisure flights during weekends).

Accordingly, the major share of airports' total costs are fixed costs. For the EU airports the share of fixed costs is approximately 80%.<sup>50</sup> In this regard, if the MEO test of an agreement between an airport and an airline is made on the *ex ante* incremental profitability basis including price differentiation, is there sufficient grounds to assume that other airport users are not discriminated?

## **4. Analysis of application of the Market Economy Investor Principle to determination of airport charges**

### **4.1. Background information**

This chapter includes the analysis of certain aspects of the MEIP which the author found the most important in the assessment of economic advantage to airport users in case of price

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<sup>48</sup> Airports Council International Europe, ACI Europe Economics Report 2015. 2016.

<sup>49</sup> Author's estimate based on Ibid, p.10.

<sup>50</sup> Airports Council International Europe, Airport and State Aid: How to Protect both Growth and Competition. 2013.

differentiation of airport charges. This research refers to agreements concluded between airport managing bodies and airport users (airlines).

It is important to note that Commission Decision of 12 February 2004 (2004/393/EC) concerning advantages granted by Walloon Region and Brussels South Charleroi Airport to the Airline Ryanair in connection with its establishment at Charleroi (State aid case 2004/393/EC of Charleroi Airport) which was contested in the Charleroi Airport judgement was the first time when the Commission applied the MEO test to assess the existence of State aid at an airport.

The reviewed State aid cases refer therefore to the period after 17 December 2008 when the CJEU ruled to annul the contested decision of the Commission.

Other import State aid law is the Commission Decision of 27 January 2010 on State aid C 12/08 (ex NN 74/07) – Slovakia – Agreement between Bratislava Airport and Ryanair and Commission Decision of 25 July 2012 on measure SA.23324 - C 25/07 (ex NN 26/07) – Finland Finavia, Airpro and Ryanair at Tampere – Pirkkala airport. Both State aid cases are the pillars of the Aviation Guidelines regarding application of the MEIP and are analysed in the text below.

In general, price differentiation is an accepted practice by case law of the CJEU and State aid law of the Commission as a standard business practice if it complies with relevant competition and sectoral legislation. At the same time differentiated pricing policies have to be commercially justified through application of the MEO test.<sup>51</sup> In this regard “relevant competition and sectoral legislation” is Articles 101 and 102 TFEU and the Aviation Charges Directive. Articles 101 and 102 TFEU refer to incompatibility of agreements between undertakings which prevents, restricts and distorts competition within the internal market as well as abuse of a dominant position within the internal market.

The issue of price differentiation is whether such business practice is applied to selective airport users which at the same time do not discriminate other airport users. Following the Airport Charges Directive, airport managing bodies have to treat all customers equally.

Accordingly, the criteria of non-granting of economic advantage in the case of price differentiation of airport charges are as follows:

- a) *Ex ante* assessment before the decision to implement a measure.
- b) Incremental contribution to the profitability of an airport.
- c) Prospects of profitability and coherence to the airport’s overall strategy leading to profitability in the long term.
- d) Accessibility of the airport’s infrastructure to all airport users.

Three of the above mentioned criteria directly refer to the MEO test and the last one is part of the entire assessment of an economic advantage.

Besides, other specific aspects have been considered, in particular the assessment of economic advantage of dedicated (user-specific) infrastructure.

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<sup>51</sup> Supra 22, Point 62.

## 4.2. *Ex ante* assessment of profitability

The idea of the MEIP is to assess the economic behaviour of an undertaking from the point of view of a private investor where the latter is assumed to be rational, prudent and profit oriented.

In this chapter two situations are distinguished: misapplication of an *ex ante* assessment and lack of application of a formal *ex ante* assessment.

One of the case laws cited in the Aviation Guidelines is Case C-482/99 *France v Commission* (Stardust Marine case), in particular paragraph 71. Stardust Marine was a company which received loans and guarantees from one of the financial intermediaries belonging to the publicly owned Crédit Lyonnais Group. Part of the company's debt was capitalised by one of the intermediaries of the Crédit Lyonnais Group in 1994. As a result, Stardust Marine became the part of the Crédit Lyonnais Group until the latter's privatisation. After the last recapitalisation the Crédit Lyonnais Group sold Stardust Marine to another company.

After the examination of the case the Commission adopted the contesting decision because it ruled that the capital increases of Stardust Marine constituted unlawful aid. In response the French Republic brought an action to the CJEU for the annulment of the Commission's decision and put forward several pleas in law. One of them referred to the error of assessment of the Commission with regard to the conduct of the Crédit Lyonnais Group as a prudent market investor.

The CJEU held that

( ...) it is necessary to *place oneself* [emphasis added] in the context of the period during which the financial support measures were taken in order to assess the economic rationality of the State's conduct, and thus to refrain from any assessment based on a later situation.<sup>52</sup>

The above mentioned paragraph does not provide judgement whether *de facto* a public undertaking (Crédit Lyonnais Group) had carried out an *ex ante* assessment of a commercial transaction before making a decision on capital injection into the Stardust Marine company.

It can be concluded from several paragraphs of the judgement that the financial intermediary did such assessment but, in the opinion of the Commission, performed it as "consistent and deliberate policy of boosting Stardust's growth on more favourable financial terms".<sup>53</sup>

The CJEU judged that the Commission misapplied the MEO test because it did not examine loans, guarantees and recapitalisations to Stardust Marine at the period when they were granted.

In author's view, the scope of transaction and formal procedures of assessment of a commercial transaction in an undertaking are important to assess the existence of an *ex ante* assessment. Usually undertakings make commercial decisions based on rules approved by the management body of an undertaking. When the Crédit Lyonnais Group made a decision to increase the capital of the company in question, it followed the standard procedures of the bank. This was not a situation where the undertaking had to "reconstruct" the *ex ante* profitability analysis as such analysis was already done beforehand. The argument is about possible misapplication of the criterion of the market economy investor committed by the intermediary of the Crédit Lyonnais Group.

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<sup>52</sup> Judgement in *France v Commission*, C-482/99, EU:C:2002:294, para. 71.

<sup>53</sup> *Ibid*, para. 74.

Another reference judgement which was made after the Stardust Marine case was the CJEU judgement in Case C-124/10 P *European Commission v EDF*. This case refers to dispute between the French Government and the Commission concerning the tax advantage to *Électricité de France*, the state owned company which produces, transmits and distributes electrical energy in France. The Commission attempted to set aside the judgment of the General Court, however, the CJEU dismissed the appeal.

The CJEU held that

( ... ) it may be necessary *to produce evidence* [emphasis added] showing that the decision is based on economic evaluations comparable to those which, in the circumstances, a rational private investor in a situation as close as possible to that of the Member State would have had carried out, before making the investment, in order to determine its future profitability.<sup>54</sup>

The CJEU did not further clarify on of the legal format of the evidence to be submitted.

To the contrary of possible misapplication of an *ex ante* assessment, another situation is when there is no formal confirmation (evidence) for such assessment.

Most of the Commission's decisions in State aid cases regarding commercial transactions among airport managing bodies and airport users are based on the initiation of a formal investigation procedure provided for in Article 108(2) TFEU instead of State aid pre-notifications or notifications initiated by Member States (see the case law of the Commission in the Bibliography where State aid cases are numbered with abbreviations "NN" which stands for "not notified").

In quite many State aid cases the Commission could not receive material legal evidence from a Member State in question with regard to application of an *ex ante* assessment of profitability of the measure in question. In practical terms it means the existence of a business plan which is prepared by in-house or external experts and approved by the highest managing authority in charge of the airport managing body. As an example, the analysis of the Commission Decision (C 2017) 5530 of 9 August 2017 State Aid SA.44377 2016 (NN) – Denmark – Aarhus Airport (State aid case SA.18855 of Aarhus Airport) is provided below.

In State aid case SA.18855 of Aarhus Airport the Government of Denmark initially did not provide the Commission with neither the agreement with Ryanair nor the business plan of Aarhus Airport. However, upon request of the Commission, Denmark finally provided copies of two agreements between Aarhus airport and Ryanair.

It should be noted that the Danish authorities did not submit a business plan of the airport in the form of a legal evidence of the *ex ante* assessment. Instead, Denmark referred to the estimates of Aarhus airport's director (and submitted to the Commission a copy of Aarhus airport's "*ex ante* calculations" and a business plan which were made retroactively after conclusion of the 1999 agreements, see recital 92 of the State aid case) and stated that those estimates were confirmed by the actual results (e.g. *ex post* evaluation versus *ex ante* assessment).

Besides, the Commission commissioned a study to an external expert who analysed the financial data and agreements signed with Ryanair but not the business plan which was not existent. In other words, the Commission instead of examining the robustness of the *ex ante* assessment prepared by the airport managing body (Aarhus airport) carried out the *ex ante* assessment on its own.

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<sup>54</sup> Judgement in *Commission v EDF*, C-124/10 P, EU:C:2012:318, para. 84.

To support the statement above, another example is the State aid case C 12/08 of Bratislava Airport. Upon request from the Commission, the airport managing body of Bratislava Airport was not able to provide the Commission with a formalised written report of the *ex ante* assessment of the agreement concluded with Ryanair (i.e. business plan, although the airport managing body claimed that it acted rationally even without the formal document). What the Commission did was “in order to be able to apply the private investor test, the Commission has to place itself at the time the Agreement was signed”.<sup>55</sup>

If an *ex ante* assessment is done retroactively without legal evidence of formal approval of the management before the decision on the commercial transaction was made, an undertaking subject to formal investigation can vitiate the assessment to fine-tune the assumptions used in the MEO test. Without an in-depth due diligence it may be difficult for an external evaluator to assess the coherence of such analysis.

It is likely that the Commission faced a similar problem in the State aid case 2004/393/EC of Charleroi Airport which was later annulled by the decision of the CJEU in the Charleroi Airport judgement. The Commission found out that the business plan submitted by the airport managing body was dated 2002, one year after the conclusion of the airport services agreement with Ryanair. The Commission asked the Belgian authorities to submit the *ex ante* business plan. Belgium did so but it cannot be concluded from the State aid decision of this really was *de facto* or restored business plan.<sup>56</sup>

The question is as follows: how can a prudent market economy investor make a business decision without its prior assessment (due diligence which besides financial analysis also includes technical, legal, environmental and perhaps other aspects of a planned measure) and legal approval? In author’s opinion, the aforementioned practice of airport managing bodies could bring a violation of the MEIP.

A prudent market investor would not allow to undertake financial obligations (e.g. signing of an agreement which is legally binding and includes certain obligations to the undertaking) without the formal consent of its top management appointed by the owners of an undertaking. According to national law (e.g. contract law, company law, insolvency law etc.), management of any undertaking has to act as a prudent manager with exercising due diligence of the company’s assets. Failure to uphold the duty of care may result in bringing a legal action against the management of a company by shareholders.

### **4.3. Incremental contribution to profitability**

Contribution to profitability includes the following characteristics:

- a) All relevant (entire) economic activities attributable to particular agreement have to be considered.
- b) Over the duration of an agreement, the airport managing body can cover all costs which are attributable to an agreement with an airport user.
- c) The airport managing body has to earn a reasonable profit margin on the concluded agreement. A “profit margin” is the rate of return on capital with a similar risk profile.

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<sup>55</sup> Supra 26, recitals 91 and 93.

<sup>56</sup> Commission Decision of 12 February 2004 (2004/393/EC) concerning advantages granted by Walloon Region and Brussels South Charleroi Airport to the Airline Ryanair in connection with its establishment at Charleroi, OJ L 137, 30.04.2004., recitals 80 and 178.

- d) An agreement has to have a feasible long term perspective where future revenues may offset losses during the first years of an agreement, if necessary.

#### **4.3.1. Entireness of a measure**

The principle of incrementalism provides for inclusion of all economic activities which are relevant to particular measure. The assessment of profitability has to take into consideration all relevant features of the measure in question. The CJEU ruled in the Charleroi Airport judgement that it was necessary to consider the commercial transaction as whole when applying the MEO test:

It is however necessary, when applying the private investor test, to *envisage the commercial transaction as a whole* [emphasis added] in order to determine whether the public entity and the entity which is controlled by it, taken together, have acted as rational operators in market economy.<sup>57</sup>

Following the preceding principle, the MEO test has to include as well the expected non-aviation revenues although such revenues is not the subject matter of agreements between the airport managing bodies and airlines. It also has to include other related economic activities, for example, costs of marketing agreements which is a common practice in business deals between airport managing bodies and airlines.

The problem is that aeronautical revenues in the MEO test are not calculated on incremental basis because they are calculated on average basis (normally eligible costs divided by the number of movements or passengers). In many airports airport charges have developed historically before the adoption of relevant EU law and therefore the relationship between airport's costs and tariffs is not straightforward.

The same constraint refers to calculation of non-aeronautical revenues. When assessing all relevant features of an agreement between an airport managing body and an airline, it is not possible to estimate correctly such revenues because they are not included in the agreement. Non-aviation services provide airport managing bodies and other airport users instead of airlines, although non-aeronautical revenues directly depend on the number of passengers using the airport.

Considering the above mentioned constraints, airport managing bodies forecast non-aviation revenues proportionally to the traffic volume of particular airline at the airport and apply average non-aeronautical revenue rates per passenger.

Incremental costs of additional agreement with an airline to a large extent depend on capacity utilisation of an airport. As explained in Chapter 3, approximately 80% of airports' costs are fixed costs therefore adding incremental aircraft rotations could have a small effect on increase of both investment and operating costs (this is particularly true for investment costs).

One exception to incremental cost savings could be ground handling costs (equipment and staff) if incremental rotations are expected to be organised in peak hours. This is particularly true for regional airports which provide feeder traffic to air hubs and have to adjust departure times of aircraft to those of departing flights from hub airports. If traffic can be organised outside peak hours, it allows an airport to be more efficient and better utilise its capacity.

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<sup>57</sup> Judgement in *Ryanair v Commission*, T-196/04, EU:T:2008:585, para. 59.



On the other hand, low cost carriers are less demanding with regard to ground handling facilities and services due to efficient organisation of terminal operations. On average the turnaround time for a low cost carrier should not exceed 30 minutes per aircraft movement.

In fact, the Charleroi Airport judgement did not result in the new case law with regard to application of the MEIP. One of conclusions of the CJEU in the preceding case was that the Commission committed an error in law because it did not applied the MEO test to joint activities of two independent legal entities, Brussels South Charleroi Airport (Belgium) and the Walloon Region.

Since the examination together of the measures at issue required the application of the private investor principle, not only to the measures adopted by BSCA but also to the measures adopted by the Walloon Region, it is unnecessary to consider the last part of the plea in law, namely that there was an incorrect application of the private investor principle to BSCA. *It cannot be excluded that the application of that principle to the single body made up of the Walloon Region and BSCA might have led to a different conclusion* [emphasis added].<sup>58</sup>

In the opinion of the CJEU, it is not the responsibility of the court to carry out complex economic assessments. Instead, the court makes a formal judgement of the legality of the assessment made by the Commission.

The applicant (Ryanair) claimed that application of discounts on airport charges to attract new customers was a standard practice in the aviation sector and that the agreement concluded with Charleroi Airport was the result of commercial negotiation instead of granted economic advantage. The CJEU did not analyse whether the agreements concluded between Ryanair and Charleroi Airport was a commercial negotiation or constituted State aid as this subject was not included in the findings of the court's part of the judgement. The CJEU referred to the case law of the CJEU that provision of airport services to airlines constituted economic activity (paragraph 87) and that potentially a private investor could also apply a discount scheme of airport charges (paragraph 101).

It means that the CJEU, despite the certain economic logic of arguments presented by Ryanair, left unanswered the following issues raised by the Commission with regard to application of the MEIP in the Commission Decision of the State aid case 2004/393/EC of Charleroi Airport:

- a) Reduction of airport charges (and fees of ground handling services) below the official tariffs set by authorities in charge.
- b) Guarantees granted to airport users in the event to losses.

In addition, there are as well other factors which were not addressed in the Charleroi judgement. Oswell, Metaxas and Vahida is of the opinion that the Commission neglected the case law principle of considering all features of the commercial transaction and disregarded the effects of network externalities, ancillary revenues and marginal costs.<sup>59</sup>

#### *Network externalities*

The underlying idea of network externalities is that increased traffic at an airport makes it more valuable to other airport users. The first airline in the row undertakes market risks of route commercialisation which in turn might attract new airlines and open new routes at the

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<sup>58</sup> Ibid, para. 103.

<sup>59</sup> Supra 19, p. 241.

airport in question. It means that the forecast of an induced traffic by commercial arrangement between an airport and an airline should also consider the effect of network externalities.

The above mentioned example is positive externality. However, in author's opinion, there could also be negative externalities where new agreements with airlines could divert the existing traffic to other airports or transport modes. This is especially true if airlines start competing in the same routes. For example, low cost carriers can crowd out full service carriers servicing the same destination.

Case T-165/16 *Ryanair and Airport Marketing Services v Commission* (Altenburg-Nobitz case) provides us the latest insight into the topic as the case law was adopted on 13 December 2018.<sup>60</sup> Ryanair DAC (formerly Ryanair Ltd.) and Airport Marketing Services Ltd. (a subsidiary of Ryanair) submitted a plea against the Commission for the partial annulment of Commission Decision (EU) 2016/287 of 15 October 2014 on State aid SA.26500 — 2012/C (ex 2011/NN, ex CP 227/2008) implemented by Germany for Flugplatz Altenburg-Nobitz GmbH and Ryanair Ltd (State aid case SA.26500 of Altenburg-Nobitz airport).

In the State aid case SA.26500 of Altenburg-Nobitz Airport the Commission initiated a formal investigation procedure to examine several measures at issue regarding Altenburg-Nobitz airport in Germany: investment and operating aid to the airport as well as airport services and marketing agreements concluded between the airport managing body on one hand and Ryanair and its daughter company on the other hand. The Commission ruled that the airport services agreement concluded on 3 March 2003 together with marketing services agreements of 7 April 2003 and 25 January 2010 constituted State aid to Ryanair and Airport Marketing Services.

Apart from other pleas, the complainants alleged the Commission in use of incorrect assumptions in the application of the MEO test including the ignorance of network externalities resulting from the airport managing body's (Flugplatz Altenburg-Nobitz GmbH) agreements with Ryanair and Airport Marketing Services.

According to the applicants, the Commission had to consider wider effects on route development network due to Ryanair's presence at the airport and resulting traffic increase. The Commission asked the applicants to submit a specific evidence which substantiated this argument but the applicants failed to do it. In addition, the CJEU noted that the last marketing services agreement of 25 January 2010 out of three such agreements was signed seven years after the start of Ryanair's operations at the airport and during this time period Ryanair had been the only airline offering air transport services from that airport.

The CJEU held that the Commission did not commit any manifest error of assessment by disregarding the potential effects of network externalities.

This time the CJEU addressed the issue of network externality compared to the Charleroi Airport case and rejected the applicants' complaint. As we see, the legal reasoning of Oswell, Metaxas and Vahida was not substantiated in the following case in question (two of the aforementioned lawyers represented the applicants in the State aid case SA.26500 of Altenburg-Nobitz Airport).

It can be concluded in the light of the foregoing that the existence of network externalities or any other additional features of a commercial transaction can be a valid argument in justifying

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<sup>60</sup> Judgement in *Ryanair and Airport Marketing Service v Commission*, T-165/16, EU:T:2018:952.

incremental returns if such effects have material evidence instead of hypothetical assumptions.

Another reminding conclusion from the preceding case is that the entirety of a measure may not only include a single commercial transaction (the airport services agreement of 3 March 2003 for a duration of 10 years) but also related commercial transactions during the duration of this transaction (the marketing services agreements of 7 April 2003 and 28 August 2008 and 25 January 2010).

#### *Ancillary revenues*

The concept of ancillary revenues is explained in this Chapter above where besides aviation revenues airports also earn non-aviation revenues. This is an important aspect which have to be considered in the MEO tests (and the Commission has included this in assessments of State aid cases after the Charleroi Airport judgement) because the share of non-aviation revenues amounts to substantial amount of airports' revenues (see Chapter 3). Most EU airports, especially regional airports, use a "single-till" mechanism of airport charges where all commercial activities (aviation and non-aviation) are taken into consideration when calculating the airport charges.

If an airport is not over utilised, it could be rational for an airport managing body to reduce aeronautical charges in exchange of increased traffic and higher non-aeronautical revenues. The final impact depends on several factors including the spending habits of passengers at airport terminals (low cost travellers tend to spend less money compared to full service travellers). However, it is quite evident that the airport charging system has the impact on financial viability of a commercial transaction and that the whole commercial transaction has to be analysed as set out in the case law.

Non-aviation revenues are also part of the State aid case SA.26500 of Altenburg-Nobitz Airport. The Commission in its assessment of *ex ante* profitability analysis assumed the non-aeronautical revenues per passenger based on the average amount of two preceding years (EUR 1.80 in 2008 and EUR 2.30 in 2009). The CJEU held that the Commission did not commit the manifest error of assessment of non-aviation revenues.

It can be concluded that non-aviation revenues can be calculated based on historical data if significant changes in traffic volume are not expected (the applicants were not able to prove the increase of non-aeronautical revenues per passenger due to network externalities).

#### *Marginal costs*

Oswell, Metaxas and Vahida raises an interesting argument with regard to marginal costs of regional airports when it comes to application of the MEO test. In view of the authors, in case of empty or underutilised airports a rational market investor could consider the previous investments as well as fixed operating costs of an airport as sunk costs. From this point of view, any commercial transaction will be a better off scenario compared to situation without such an agreement if marginal revenues exceed marginal costs of an airport managing body.

In author's view, such an opinion holds true only if certain preconditions are met. As it can be seen from the previously quoted research, the methodology of the MEO test is very important. Even if the MEO test is met according to assumptions approved in the methodology, it does not mean that there is no economic advantage granted.

The question is whether an airport is regional and underutilised – from this angle there could also be a different approach to the MEO test (considering historical fixed costs as sunk costs).

There is a possible conflict of interest between competition law (Article 101(1)(d)) TFEU, State aid law and the Airport Charges Directive. Article 101(1)(d) TFEU rules that agreements between undertakings are prohibited as incompatible with internal market if they apply dissimilar conditions to equivalent transactions other parties and placing the latter ones at a competitive disadvantage.<sup>61</sup> It means that a distinction has to be made between a commercial negotiation and a preferential treatment which involves State aid.

Incremental profitability can be justified if tariffs are economically justified (total revenues of the airport managing body exceeds total costs) and there is no cross-subsidisation of the airport's costs from other airport users. In order to exclude the economic advantage to an airport user under consideration, there should be no cross-subsidisation of airport's costs from other airport users. There is a break-even point when the increased traffic volume of low cost carriers allows compensating total capital and operating costs from reduced airport charges. Also, there is no economic advantage to an airport user, if other airport users have the same terms and conditions of a commercial arrangement which have an airport user at issue.

In author's view, discrimination of airport users by differentiated airport charges which result in cross-subsidisation of airport's costs should not be allowed because such practice contradicts competition law and State aid law.

The assessment of incremental costs and revenues directly depend on the number of airlines operating at the airport. If it is assumed during an *ex ante* assessment that there will be one or few airport users and especially in circumstances when an airport does not offer commercial air transport services at the time of *ex ante* assessment (like if was in the case of Altenburg-Nobitz airport), it may be logical that previous costs borne by an airport are sunk costs.

#### **4.3.2. Cost recovery**

##### **4.3.2.1. The principle of cost recovery in the absence of benchmarking**

The ideal criteria is correspondence of the airport charges (aeronautical revenues) to market price (e.g. airports' benchmarking). Benchmarking is not an adopted practice of the Commission due to lack of sufficient and comparable data (see Chapter 1.3.1).

As explained in Chapter 1.3.1 above, the principle of cost recovery is mentioned in the Chronopost case. This refers to situations where it is not possible to set a benchmark for a private investor. The objective and verifiable elements of normal market conditions in the case of an airport managing body can be the incurred costs with regard to delivery of services to an airport user. Such costs can include "all the additional, variable costs ( ... ) and appropriate contribution to the fixed costs ( ... ) and an adequate return on the capital investment ( ... )."<sup>62</sup>

What can be concluded from the Chronopost judgement is that variable costs are "additional" (e.g. incremental) and fixed costs are "appropriate" (e.g. the airport managing body in question has a discretion how to allocate the fixed costs of an airport to particular commercial transaction). The judgement provides three constituent elements of the cost analysis, namely, variable costs, fixed costs and return on the investment.

The Commission generally considers price differentiation as a standard business practice, especially to attract new airport users, and that such differentiated pricing policies do not

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<sup>61</sup> Supra 11, p. 89.

<sup>62</sup> Supra 26, para. 40.

constitute selective advantage *per se*, if they can be commercially justified and thus comply with the MEO test, i.e. they do not constitute State aid.<sup>63</sup> In the MEO test all incremental costs should be taken into account including operating and investment costs.

To understand the application of the MEO test, a distinction has to be made between full costs, average costs and incremental costs.

Full costs refers to application of all operating and investment costs of an airport managing body to an agreement concluded with an airport user. This is a rare practice and can be used in cases if services of an airport are provided to a sole airport user (see Chapter 4.3.5 with regard to dedicated infrastructure).

Application of average or incremental cost recovery is applied in cases where several airport users benefit from the same airport infrastructure and services. In this regard we refer back again to the Charleroi Airport judgement and the Commission's decision which was contested by Ryanair, the State aid case 2004/393/EC of Charleroi Airport.

Robins and Geldof rightly observed that in the aforementioned State aid case the Commission analysed the expected profitability of the airport's agreements with Ryanair and where it used both incremental and average cost approach.<sup>64</sup> Authors of the article are of the opinion that such methodology conflicts have been resolved in the Aviation Guidelines and following State aid decisions.

#### **4.3.2.2. State aid case 2004/393/EC of Charleroi Airport**

The below author has provided the analysis of the State aid case 2004/393/EC of Charleroi Airport.<sup>65</sup>

Charleroi Airport is located in Brussels, Belgium. At the time when the Commission initiated a formal procedure against Belgium, the airport was not subject to the Airport Charges Directive. The biggest airport of Belgium still is another airport in Brussels: Brussels-National (Zaventem) Airport.

The Walloon Region, one of the owners of Charleroi Airport in Brussels, signed an agreement with Ryanair in 2001. The airport managing body of the airport is a public sector company owned by the Walloon Government. This agreement included 50% reduction in airport landing charges compared to the amount fixed by the Walloon Government for airports in the Walloon Region – Charleroi and Liege.

The landing charges applied in the agreement with Ryanair were calculated per embarking passenger while the official price list of the Walloon Government was based on the tonnage of an aircraft. The Commission made a comparative analysis of airport charges based on identical aircraft (Boeing 737-200 and 737-800 used by Ryanair) and concluded that Ryanair had to pay EUR 104 and EUR 151 accordingly per aircraft rotation compared to EUR 250 and EUR 390 according to the general rules of the Walloon Government.

In addition, the Walloon Region provided to Ryanair a business risk insurance in a way that Ryanair was subject to compensation of loss profit in case of increase of airport charges during the agreement's period of 15 years (2001-2016) unless regulated otherwise by legal

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<sup>63</sup> Supra 4, recital 62.

<sup>64</sup> Robins, Nicole, Geldof, Hannes, "The Ryanair Charleroi Judgment: What Is Its Legacy?" in *Milestones in State Aid Case Law*, p. 256.

<sup>65</sup> Supra 54.

acts of the central government, the EU, International Civil Aviation Organisation or other international law. The advantages conferred to Ryanair were not published and consulted with other airport users.

The airport managing body and Ryanair also established a joint marketing company to advertise Charleroi Airport. Promotional activities were financed in the same proportion by both parties.

As explained in Introduction, analysis of ground handling services is outside the scope of the Master's Thesis. However, it has to be mentioned in the context of analysed State aid case that the airport managing body of Charleroi Airport provided to Ryanair as well discounts on ground handling fees. The Commission applied the MEO test only to the agreement concluded between the airport managing body and Ryanair.

In return of above mentioned, Ryanair obliged to open a base at Charleroi Airport (including two to four aircraft) and offer minimum three rotations per aircraft a week over a 15-year period. Had Ryanair decided to cancel operations at Charleroi Airport, it would have to repay the appropriate proportion of marketing costs and the costs of the airport managing body related to establishment of Ryanair's base.

The Commission invited interested parties (airlines) to submit their comments pursuant to the investigation. The rival airlines SAS, KLM, Air France and Austrian Airlines pointed out that deregulation of European airspace has led to increased competition and emerge of new airline business models (in particular low cost carriers). It is important that this increased competition complies with the existing aviation regulatory framework in a non-discriminatory and transparent manner.

Both airline business models of full service and low cost service are needed to customers, however, any of these models cannot be supported by unlawful aid. In this regard a network effect to Ryanair has to be considered as well. Even if there is not a direct competition in the route from Charleroi Airport, such competition can be distorted in another intra-EU airport where other full service airlines compete with Ryanair.

On the contrary, a private airport managing body TBI (owner and operator of London Luton Airport) argued that public airports needed to adopt commercial practices of private airports and that low cost carriers were the main drivers of under-utilised regional airports instead of full service airlines concentrated around their home airports which are located in air hubs. Another private airport operator, Infratil, argued that it wanted to attract full service airlines at Glasgow Airport but failed, and thanks to Ryanair the airport reached its break-even point. Ryanair echoed private airport managing bodies that it helped to increase traffic, develop regions and, at the end, benefit consumers. Ryanair claimed that major airports were monopolies and they had to lower their costs and increase efficiency.

The Belgian Government commented to the Commission that Belgium carried out an aviation reform and transferred regional airports to the regions in 1998. In 2000, the Walloon Government approved a big investment programme for Charleroi Airport in amount of EUR 113.7 million. When doing this, the Walloon Government new about the problem which faced all regional airports in the EU. According to the University of Cranfield study, an airport cannot cover its operation costs if the volume is less than 1 million passengers per annum.<sup>66</sup>

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<sup>66</sup> Supra 56, recital 83.

However, it should be noted that the airport managing body in four subsequent years before concluding the agreement with Ryanair demonstrated positive net profit. Presumably this is due to public financing of the airport's non-economic activities.

In order to reach the break-even and to raise financing for investment costs, airports need at least 3 million passengers per annum. The Walloon Region was aware of this and tried everything possible to attract airlines to the airport.

Following the information received from involved parties, the Commission made the assessment of existence of State aid – an economic advantage granted to Ryanair.

The Commission recalled first that granting of reductions of airport charges as such does not violate State aid law. The Commission was of the opinion that economic advantage through reduced airport charges was granted to Ryanair only instead of other airlines operating at the airport.

However, the Commission considered that application of the MEO test was not subject to decision of the Walloon Region to lower airport charges as the latter exercised its official powers instead of performing an economic activity. The Commission concluded that reduction in airport charges and award of the compensation guarantee conferred an advantage and constituted State aid to Ryanair because it allowed to reduce operating costs. This opinion of the Commission with regard to the role of the Walloon Region was later recognised as an error in law in the Charleroi Airport judgement.

Among several errors of judgement in the business plan which are not analysed here (including the fact the business plan was made for the entire undertaking instead of the single agreement), the Commission found unjustifiably variable cost margin covered by high incremental operating revenues per new passenger. In view of the Commission, the airport managing body would not be able to charge such high margins on the airport's services. The Commission believed that a private investor would not risk investing in a ground handling business where it would be exposed to legal risk resulting from closing down the ground handling market at the airport or lack of transparency of service fees due to likely cross-subsidisation.

The Commission concluded that, besides inconsistencies with regard to risk assessment in the business plan, a private market investor would not have entered into the agreement because the legal assurance from the Walloon Region that it would continue bearing part of the airport's costs in the future (for example, firefighting and rescue costs which were part of non-economic activities but were planned to be transferred to the airport managing body).

In addition, the proposed measure to Ryanair was selective as other airlines did not enjoy the same opportunities. The contract's terms were confidential, different from the official price list of the Walloon Region and the public authority could not produce the evidence of established transparent system of airport charges with volume discounts. It should be mentioned that this contradicted the non-discrimination principles set forth in the Airport Charges Directive.

After compatibility analysis of the measure, the Commission held in the State aid case 2004/393/EC of Charleroi Airport that the Walloon Region granted unlawful aid to Ryanair in the form of reduced airport landing charges beyond the official tariffs approved by the Walloon Government. The same decision referred to the application of reduced ground handling fees by the airport managing body to Ryanair.

In fact, the Commission's decision in the above mentioned State aid case does not say very much about the application of the MEO test, in particular the incremental profitability analysis. Nevertheless, the Commission acknowledged the situation that there were limits to increase the tariffs to finance the costs of the airport. Calculations of the Commission led to conclusion that Charleroi Airport was not able to finance its costs with the planned policy of reasonable increase of tariffs.

In this regard we refer back again to high proportion of fixed costs of airports. The Britannia airline provided a notable comment in the context of the analysis provided in this Chapter.

The airport taxes are unequal and unrealistic while the low-cost companies use runways, terminals and security facilities in the same way as the other airlines.<sup>67</sup>

Regardless of the scope of analysis, it can be concluded that the Commission changed the approach to the MEO test methodology not because of discovered manifest error in the Charleroi Airport judgement but due to some other reasons. One of them could be the difficulty of application of the MEIP due to mixed up roles of the Walloon Region as public authority and Charleroi Airport as an undertaking.<sup>68</sup>

In this long-going battle between low cost carriers, public regional airports and private airports on one hand and full service carries on the other hand, the first ones achieved success. In author's view, the Charleroi Airport judgement, perhaps due to successful litigation strategy of Ryanair, provided substantial benefits to Ryanair and presumably other low cost carriers with regard to business development in regional airports of the EU. Behind the cover of "commercial negotiations" and "incremental profitability" Ryanair managed to get agreements with airport managing bodies which boosted its business and, of course, improved connectivity and traffic volumes at regional airports.<sup>69</sup> The question remains which stakeholders, including society as a whole, carried the try costs of such commercial transactions.

An important conclusion which can be derived from the analysis of the State aid case 2004/393/EC of Charleroi Airport (and other State aid cases covered as well in the Master's Thesis) is that airport managing bodies perhaps do not take the priority of the incremental profitability of particular agreement with an airline as long as they get operation and investment aid from their owners. This strategy can turn out to be feasible if the traffic increase is big enough to reach the airport's break-even point in a certain period of time.

#### **4.3.2.3. The State aid case C 12/08 of Bratislava Airport**

The Commission further developed the principle of incremental profitability in the State aid case C 12/08 of Bratislava Airport. Bratislava Airport concluded a service agreement with Ryanair in 2005 for duration of 10 years. The Commission made a comparative analysis of the airport charges and found out that effective service charges to Ryanair for new and existing routes were lower than those published in the airport's official price list. The reference aircraft was Boeing 737-800 used by Ryanair.

Considering that fact that the airport managing body could not deliver an *ex ante* business plan, the Commission constructed the MEO test. The Commission outsourced an external expert who verified the financial data at the premises of the airport managing body. "The

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<sup>67</sup> Ibid 54, recital 19.

<sup>68</sup> Ibid 56, recital 161.

<sup>69</sup> See for example Supra 64, p. 260.



expert had unlimited access to the airport's financial, contractual and other documentation.”<sup>70</sup> (see also Chapter 4.2 above).

With regard to the cost base of the measure, the Commission used a “full-cost approach” because it included all relevant costs: operating costs, depreciation costs of the existing infrastructure, depreciation costs of the new terminal and even the safety and security costs falling within the public policy remit. For additional information with regard to “full-cost approach” and dedicated infrastructure please refer to Chapter 4.4.

Based on the covenants of the service agreement, the Commission made a forecast of operating revenues which were based on traffic forecast (number of aircraft turnarounds and average load factor). Afterwards the Commission established the system of “cost allocation key” where a combination of keys (passenger share, maximum take-off weight of an aircraft, aircraft movements at the airport and airport's administration) was applied to each cost position.

In author's opinion, this is a good and fair system because it considers the fixed costs of the airport proportionally the traffic volume, nevertheless this is rather an “average approach” instead of an “incremental approach”.

The NPV of the agreement during its life cycle of ten years was positive therefore the Commission concluded that the measure did not confer State aid to Ryanair.

During the investigation the Commission did not find the evidence of price discrimination as the only available benchmark airline at the airport, Sky Europe (the biggest carrier operating at the airport at the time when the agreement was concluded with Ryanair), paid similar charges per passenger to those of Ryanair. In the Commission's opinion, differences of airport charges were non-discriminatory because such the criteria of differentiation were the service level and the carried volume of passengers.

The State aid case C12/08 of Bratislava Airport, as explained above, is one of two State aid cases quoted in the Aviation Guidelines and has a direct reference as an example of commercially justified differentiated pricing policy, and is justified by average cost recovery approach rather than incremental approach.

#### **4.3.2.4. The State aid case of Berlin SA.15376 of Berlin-Schönefeld Airport**

One of the most extensive analysis of price differentiation is provided in the State aid case SA.15376 (C 27/07, ex NN 29/07) Flughafen Berlin-Schönefeld GmbH and various airlines (State aid case SA.15376 of Berlin-Schönefeld Airport).

Berlin-Schönefeld Airport is one of two currently operating airports in Berlin (the third one, Tempelhof Airport, was closed in 2009). According to plans of German authorities, a brand-new airport of Berlin-Brandenburg has been built next to the Berlin-Schönefeld Airport to accommodate the whole air traffic in Berlin. This new airport is not yet functional due to technical and legal reasons, and the German government submitted several State aid notifications to the Commission for legal certainty.<sup>71</sup>

When the Commission opened a formal procedure against Germany in 2007, Berlin-Schönefeld Airport was the second biggest airport after Tegel Airport and serviced 6.3 million passengers in 2007. This traffic volume includes the effect of low cost airlines which started

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<sup>70</sup> Supra 27, recital 86.

<sup>71</sup> Supra 31.

operations in Berlin-Schönefeld Airport during 2003-2004. Before that period the business performance of the airport was less attractive as it serviced only 1.7 million passengers in 2003. According to the Commission, Berlin-Schönefeld Airport operated at a loss at least until 2006.

While operation of Tegel Airport was close to its capacity, Berlin-Schönefeld Airport was underutilised. The airport managing bodies of both airports tried to move traffic from one airport to another but they did not succeed due to marketing reasons of airlines and less developed infrastructure at Berlin-Schönefeld Airport. These disadvantages were not offset by the offer of acceptable airport charges.

The airport managing body, publicly owned company Flughafen Berlin-Schönefeld GmbH (FBS), being part of the holding company Berlin Brandenburg Flughafen Holding GmbH (BBF) which owned both airports, sought opportunities to increase the traffic volume at the airport.

Before 2003, all airports had single schedule of airport charges. BBF changed the pricing system and introduced differentiated charges for each airport. Besides, to the contrary of State aid cases described in Chapter 4.2, the airport holding company commissioned an *ex ante* study to improve the financial position of Berlin-Schönefeld Airport. More than that, BBF commissioned another (the first) study in 2007 to stress test the first study made in 2003.

Following recommendations of an external consultant, BBF decided to launch the Low Cost Carrier Strategy including volume-based discounts of airport charges together with financial incentives to attract low cost carriers to the airport. In 2003, FBS signed the airport service agreement with the low cost carrier easyJet for a period of 10 years. This airline became the “anchor tenant” at the airport to attract other airlines according to the Low Cost Carrier Strategy.

Afterwards FBS signed agreements with seven other airlines including six low cost carriers. The impact of induced traffic of low cost airlines was remarkable as the traffic volume increased by 471% in 2007 compared to 2003.

The Commission examined three measures in the formal investigation procedure including the concluded agreements between FBS and airlines which is the focus of analysis in this Chapter. In view of the Commission, the German government had to find the optimal strategy for operation of Berlin-Schönefeld Airport up to the opening of the brand-new Berlin Brandenburg Airport.

The Commission carried out the options analysis based on available information and concluded that the option of pursuing the Low Cost Carrier Strategy was preferable to alternative options of retaining the previous business model or closing down the airport from the perspective of a prudent market economy investor guided by medium to long-term profitability prospects.

The Commission referred to the Charleroi Airport judgement that discounts to airport charges did not automatically confer an economic advantage. In order to assess if such discounts confers and advantage, it is needed to assess of a private market investor guided by profitability prospects had offered the same discounts.<sup>72</sup>

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<sup>72</sup> Supra 9, recital 184.

In the *ex ante* business plan BBF had included the counterfactual analysis of the potential agreement with easyJet. The analysis demonstrated operating profit without easyJet, additional profit with EasyJet and consolidated operating profit of BBF. The Commission also took into account the analysis of the second study commissioned in 2007 by BBF to assess if FBS acted as a prudent market investor in 2003 when it concluded the agreement with EasyJet. The second study found that the measure in question generated positive NPV to FBS.

Besides, all other agreements with airlines were also assessed on an *ex ante* basis and calculations were verified in the second study of 2007. All agreements demonstrated positive NPV to FBS.

In view of the Commission, the above mentioned assessment included all relevant incremental costs and revenue factors like the number of expected light movements, average load factors, aeronautical and non-aeronautical revenues, costs of the financial incentives and others.

Accordingly, the Commission decided that agreements concluded by the airport managing body with easyJet, Ryanair, Germanwings, Volare, V-Bird, Icelandair, Norwegian Air Shuttle and Aer Lingus did not confer an economic advantage to aforementioned undertakings.

The case of Berlin-Schönefeld Airport is a good example how, in author's opinion, the airport managing body acted as a prudent market economy investor. BBF designed the *ex ante* strategy and implemented it afterwards. Differentiated pricing led to the rapid increase of traffic volume and improved financial performance reaching the break-even of the airport's operations.

#### **4.3.2.5. Impact of operating revenues on cost recovery**

Price differentiation has to be analysed from two angles: operating revenues and operating costs because airport charges to large extent reflect the costs (both operating and investment) of an airport managing body.

As regards the revenues side of an airport managing body, it includes aviation revenues and non-aviation revenues. The assessment of contribution to incremental profitability of a measure is not the same for aviation revenues and non-aviation revenues.

Non-aviation revenues are usually included in the revenue forecasts of airports' business plans as the total sum of historical revenues divided by the number of serviced passengers. There are some costs attributed to non-aviation services (dedicated spaces in terminals for shops, parking stands etc.), however they are not the major costs borne by airport managing bodies.

On the contrary, aviation revenues are calculated as the unit rate per aviation charge multiplied by physical quantity of provided service. For example, revenues from landing/take-off can be calculated as charge per ton of maximum take-off weight of an aircraft multiplied by the weight of an aircraft. Aviation charges are calculated as total costs (fixed and variable) divided by the expected traffic volume (in the aforementioned case the number of movements and average weight of an aircraft). That is to say, calculation of aviation charges is based on the average approach.

Almost all State aid cases of the Commission include low cost carriers as involved parties. The business model of low cost carriers is different to that of full service carriers. Low cost carriers try to bargain with airport managing bodies on lump-sum (all-inclusive) airport

charges per departing passenger and an all-inclusive ground handling per turnaround of an aircraft.

Besides, low cost carriers also use price scaling of an all-inclusive fee per passenger. The bigger is the total amount of carried passengers per year, the smaller is the fee per passenger. Low cost carriers tend to use a rather big aircraft with capacity of at least 180 seats and reach the load factor above 80% to provide economies of scale. It means that such airlines try to reduce the service cost per seat which may also lead to reduced number of movements. Airport managing bodies, on the other hand, have to cover their fixed costs. The previously mentioned business model is profitable for airport managing bodies if the traffic volume is sufficient to generate substantial amount of non-aviation revenues (see the description of the “single-till” model in Chapter 3).

Without detailed information and analysis it is impossible to determine the extent to which such “commercially negotiated” fees contribute to the cost recovery of an airport.

The only evidence is financial performance results of an entire airport managing body: if an undertaking runs the airport at reasonable profit, it means that negotiated tariffs with airport users are sufficient to ensure sustainable operation.

As mentioned in Chapter 3, 80% of airports’ costs constitute fixed costs. If the so called incremental revenues approach is applied in the commercial transaction’s profitability assessment and the service charges of commercial transaction are used instead of uniform aviation charges set by an airport managing body, the particular airport cannot cover all its costs. It means that other undertakings will cover such costs or the airport managing body will need State aid in the form of investment or operating aid (including aid provided under the framework of services of general economic interest).

If availability of State aid is limited, the airport managing body in question will not be able to sustain its operations. Evidence to this statement can be found in the State aid case SA.44377 of Aarhus Airport.<sup>73</sup> The Danish authorities notified to the Commission State aid (both investment aid and operating aid) for Aarhus airport in 2016, two years after the Commission’s decision in the State aid case SA.18855 of Aarhus Airport where the Commission found that Aarhus airport did not provide State aid to Ryanair (see Chapter 4.3.1 above).

According to the business plan of Aarhus airport, four airlines will provide services from the airport in the future (SAS, Ryanair, Aarhus Charter and CSA). The question is to what extent Aarhus airport acted as a prudent market investor in 1999 when it concluded agreements with Ryanair and were there opportunities to improve the financial position of the airport in the future as of 2016 and afterwards.

In addition, it can be concluded from the State aid case SA.44377 of Aarhus Airport that an important aspect of profitability assessment is treatment of non-economic activities of an airport. The Danish authorities stated that Denmark did not have a general legal framework with regard to financing of public merit functions across all airports in the country. Consequently, services of non-economic nature like firefighting, security, police and customs were included in the airport’s charges as such costs were related to economic activities of the airport.

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<sup>73</sup> Commission Decision (C 2017) 5530 of 9 August 2017 State Aid SA.44377 2016 (NN) – Denmark – Aarhus Airport, OJ C 121, 06.04.2019.

#### 4.3.2.6. Impact of non-economic activities on cost recovery

Conversion of non-economic activities into economic activities increases airport tariffs and accordingly operating aid to the airport. It also affects the funding gap calculation of investment aid because the costs of non-economic nature are included in the business plan as costs of economic nature.

There are countries in the EU where non-economic activities of airports are financed by State versus countries like Denmark where public financing of public remit functions is limited or not available. It affects the competitive position of cross-border airports which have overlapping catchment areas because public remit costs like security measures can amount to considerable share of airports' costs. In negotiations of commercial transactions with airlines the airports of public financing for non-economic activities have advantage to other airports because they can offer lower airport charges.

The Commission has raised similar doubts in the State aid case 2004/393/EC of Charleroi Airport. It cannot be effectively verified if public financing provided for public remit functions of the airport does not lead to cross-subsidisation of its economic activities.<sup>74</sup>

Following the previous arguments, it is not straightforward that differentiated pricing policies can always be "commercially justified".

#### 4.3.3. Rate of return on the investment

According to the Commission Notice on the Notion of State Aid, a discount rate should be used for discounting cash flows in a way that reflects the opportunity cost of capital. The Aviation Guidelines does not provide any guidance in this regard.

The question is whether the discount rates applied in State aid cases reflect the true cost of capital and what is the result of sensitivity analysis of the discount rate on the outcome of the MEO test. In this regard, the most appropriate proxy for a discount rate is the WACC which reflects a return on alternative investment with a similar risk profile.

Table 1 includes applied discount rates of selected State aid cases of the Commission. Although this is a sample of all State aid cases which examines airport operations, most of State aid cases refers to regional airports (according to both ACI Europe and the Commission's classification) and are not subject to the Airport Charges Directive (i.e. the annual number of passengers is below 5 million and an airport is not the biggest airport in a Member State).

State aid case	Discount rate	Application of WACC/CAPM
State aid case SA.24221 of Klagenfurt Airport (Austria), 11 November 2016	8% (a benchmark used from Vienna Airport). Note of the author: Vienna Airport is a hub airport according to ACI Europe classification.	The cost of capital (8%) was calculated according to the WACC methodology
State aid case SA.23098 of Alghero Airport (Italy), 25 September 2015	2.45% (agreement with Alitalia), 6.42% (agreement with Volare), 2.24% (agreements with Meridiana, Air Vallee and Bmibabby),	No reference

<sup>74</sup> Supra 56, recital 166.

State aid case	Discount rate	Application of WACC/CAPM
	6.42% (agreement with Germanwings), 6.0% (agreement with Air Italy)	
State aid case SA.26500 of Altenburg-Nobitz Airport (Germany), 15 October 2014	Germany did not provide any discount rate. The Commission applied the Germany's reference rate of 4.80% for the discount rate in the MEO test	Reference that Germany did not provide information on the weighted average cost of capital
State aid case SA.21121 of Frankfurt-Hahn Airport (Germany), 1 October 2014	Restricted access information	No reference
State aid case SA.18855 of Aarhus Airport (Denmark), 20 February 2014	8.5% (the first agreement with Ryanair) and 15.0% (the second agreement with Ryanair)	No reference
State aid case SA.15376 of Berlin-Schönefeld Airport (Germany) of 20 February 2014	Not mentioned	The CAPM applied to calculate the discount rate for agreements with airlines easyJet, Ryanair, Germanwings, Volare, Icelandair, Norwegian Air Shuttle and Aer Lingus. Note of the author: Berlin-Schönefeld Airport falls outside the scope of the Commission's definition of regional airport
State aid case SA.23324 of Tampere-Pirkkala Airport (Finland), 27 July 2012	Not mentioned	Reference is made to the benchmark ROE of 4% but it is not clear if it has been used as the costs of capital
State aid case C 12/08 of Bratislava Airport (Slovakia), 27 January 2010	6.9%	No reference

*Table 1. Applied discount rates in the MEO tests for agreements among airport managing bodies and airlines in State aid decisions of the Commission*

*Source: author, based on selected State aid cases of the Commission*

Following from the table above, in the author's selected cases only one airport managing body, Berlin-Schönefeld Airport, used the WACC/CAPM as a proxy of the cost of capital. It should be noted that Berlin-Schönefeld Airport is rather a hub airport and can be compared to airports listed on stock exchange (the airport itself is not a listed company). As explained above in Chapter 1.3.5, neither the Commission Notice on the Notion of State Aid nor the Aviation Guidelines include a notion of the WACC.

It can also be concluded that not in all cases the airport managing bodies or national authorities are willing to disclose the financial data concerning the application of discount rates. Besides, in some cases where data on discount rates are not available from airport managing bodies (see Chapter 4.2 above where the analysis is made with regard to *ex ante* profitability of commercial transactions among airport managing bodies and airlines) the

Commission has applied reference rates of particular country according to the Commission Communication on Reference and Discount Rates.

According to the case law, it is not up to the CJEU to make judgement with regard to calculation of the discount rate because the CJEU relies on the assessment made by the Commission in decisions which are contested and brought to the court. In Case T-296/97 *Alitalia v Commission* the CJEU held that “it is not for the Court ( ... ) to reassess the minimum rate and the internal rate for the investment or to decide whether a private investor would have made the investment ( ... ).”<sup>75</sup>

Although this is a legally allowed practice, in author’s view, such reference rates do not reflect the true cost of capital of airport managing bodies. Reference rates are based on the information of financial markets (cost of money and cost of lending risks) and do not reflect the expectations of private investors with regard to return on the investment. This supports the argument stated in Chapter 4.2 above that legally grounded *ex ante* and restored (retroactive) *ex ante* assessments could not lead to the same results of market investor’s decisions to engage in commercial transactions.

In order to verify the relevance of applied discount rates in State aid cases to the cost of capital according to the methodology of the WACC, the tables below includes calculation steps of the discount rate (CAPM) for a hypothetical airport managing body. The calculation of the discount rate was made according to the formula provided in Chapter 1.3.5.

The risk-free investment rate is different for each Member State (for example, the long-term bond issue rate of the State), therefore the author used the annual 1.250% coupon rate of 15 year euro bonds of the Commission.<sup>76</sup>

Calculation of the capital market risk premium is not an easy task because only few airports are listed on the stock exchange. Needless to say that regional airports according to classification of the General Block Exemption Regulation (annual passenger turnover less than 3 million) are not among listed companies. The author has selected the following listed airport managing bodies:

- a) Malta International Airport Plc (Malta).
- b) Flughafen Wien AG (Austria).
- c) Flughafen Zuerich AG (Switzerland, which is not the EU country but still part of the single market according to signed bilateral agreements).
- d) Toscana Aeroporti SpA (Italy).

Table 2 provides calculation of the average return on equity (ROE) during 2010-2016 for each airport managing body. The author calculated average ROE values of airport managing bodies based information available in their websites.

Airport managing body	Number of passengers (2016)	Share of passengers	ROE (average values 2010-2016)	ROE (weighted values)
1	2	3	4	5=3*4

<sup>75</sup> Judgement in *Alitalia v Commission*, T-296/97, EU:T:2000:289.

<sup>76</sup> European Commission. Investor Presentation. May 2019.

Malta International Airport Plc	5 080 071	8.0%	21.8%	1.7%
Flughafen Wien AG	23 352 016	36.8%	8.2%	3.0%
Flughafen Zuerich AG	27 666 428	43.6%	8.5%	3.7%
Toscana Aeroporti SpA	7 319 912	11.5%	7.1%	0.8%
Total	63 418 527	100.0%		
The average value of ROE			11.4%	9.3%

Table 2. Average value of the return on equity of selected airport managing bodies

Source: author, based on the websites of airports

Airports like Copenhagen Airport and Frankfurt Airport were excluded from the sample, because the former had unusually high return on equity (average 35% during 2010-2016, author's estimates) and the latter was network airport with subsidiaries across the world.

Table 3 below includes calculation of beta factor.

Airport managing body	Number of passengers (2016)	Share of passengers	Beta (nominal values)	Beta (weighted values)
1	2	3	4	5=3*4
Malta International Airport Plc	5 080 071	8.0%	0.8679	0.0695
Flughafen Wien AG	23 352 016	36.8%	0.4960	0.1826
Flughafen Zuerich AG	27 666 428	43.6%	0.6930	0.3023
Toscana Aeroporti SpA	7 319 912	11.5%	0.2791	0.0322
Total	63 418 527	100.0%		
The average value of ROE			0.5840	0.5867

Table 3. Average value of beta factor

Source: author, based on the Financial Times, available on: <https://markets.ft.com>

It can be seen from the table above that average beta factor of the sample is less than one (0.5867). It means that in the sector of airport services the risk level is lower than the average market risk level.

Table 4 includes the final calculation of the cost of capital.

Risk free rate ( $R_f$ )	Beta ( $\beta_i$ )	ROE ( $r_m$ )	Cost of capital ( $R_i$ )
1	2	3	4=1+2*(3-1)
1.250%	0.5867	9.3%	5.97%

Table 4. Calculation of the cost of capital of a hypothetical airport managing body

Source: author

According to the table above, the discount rate using the CAPM is 5.97%.



By comparing the results of Table 1 and Table 4 above, it can be seen that in general the cost of capital used in the State aid decisions (range 6 percentage points, the lower value 2.24% and the upper value 8.0%) is not very deviated from the calculated cost of capital in line with the CAPM. However, it is likely that the cost of capital of airport managing bodies according to the WACC method is higher than discount rates applied in State aid decision (see the example of Klagenfurt Airport).

It should be kept in mind that the WACC is made of two parts, the cost of debt and the cost of equity. The cost of debt in the current macroeconomic outlook of the EU is lower than the cost of equity, therefore the aggregate cost of capital depends on the share of debt and equity financing in the undertaking's balance sheet.

Although the methodology of calculation of the cost of capital could be negotiable on a case by case basis (including the calculations made in this Master's thesis), it is quite evident that the financing structure of almost every airport in the EU consists of debt and equity financing. For this reason it would be coherent to consider both financing sources in calculation of an airport's total cost of capital.

This is not a simple task, because the business environment differs among airports. The benchmark cost of capital depend on the airport's catchment area and competitive position to other airports, business model, historical record, traffic volume and forecast and other factors.

#### **4.3.4. Long term perspective**

The principle of long term perspective includes two aspects. First, a commercial transaction has to be analysed in the long-term perspective in case if it cannot be profitable in the short to medium term. Second, a commercial transaction has to benefit to the long-term profitability of the entire undertaking. The latter one is a qualitative judgement which contributes to quantitative analysis of the MEO test.

According to Case T-296/97 *Alitalia v Commission*, “the conduct of a private investor in a market economy is guided by prospects of profitability”.<sup>77</sup> Besides the prospects of profitability, the time horizon of profitability is also important.

The CJEU held in Case C-305/89 *Italy v Commission* that to the contrary of short-term interests a private investor may be guided by prospects of profitability in the long term.<sup>78</sup> It follows that the MEO test has to be carried out during the duration of an agreement signed between an airport managing body and an airport user.

In addition to the MEO test, the Commission decided in the State aid case C 12/08 of Bratislava airport that the concluded agreement between the airport managing body and Ryanair made Bratislava Airport more profitable. In its judgement the Commission referred to the Charleroi Airport judgment that *ex ante* MEO test should include all relevant features of a measure.<sup>79</sup>

The Commission concluded that the airport managing body was able to diversity the customer base and attract new airline to the airport. The airport managing body was dependant on one

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<sup>77</sup> Supra 75, para. 84.

<sup>78</sup> Judgement in *Italy v Commission*, C-305/89, EU:C:1991:142, para. 20.

<sup>79</sup> Supra 27.

airline (Sky Europe) which carried 73% of the airport's passengers in 2005, the year when the airport managing body concluded the agreement with Ryanair.

Besides, the airport managing body reduced the risk of overcapacity of the new terminal when it decided to replace the old terminal with the new one. This conclusion is rather not obvious because the airport managing body had decided to build the new terminal before signing the agreement with Ryanair and it should have based its investment plans on prudent traffic forecasts.

In the context of overcapacity, how can it be proved in the moment of making a market investor's decision that award of an agreement with differentiated airport charges will not divert away the existing traffic of competing airlines? This aspect at least has to be assessed in an *ex ante* business plan. It can be seen from the State aid case SA.18855 of Aarhus Airport that traffic volume went down after conclusion of an agreement with Ryanair. The question remains if the traffic volume would have more deteriorated without the presence of Ryanair at Aarhus airport.

Not only overcapacity but also under-capacity is also an issue of the long-term sustainability. A high share of non-incremental (mostly fixed) costs and spare capacity would lead to operating losses of the airport in the future.

The principle of incremental profitability also includes the requirement of a measure to be part of the airport's strategy leading to profitability in the long run. The impact on the long-term profitability resulting from the change in a business model could also affect the MEO test (for example, switching from domestic to international flights).

#### **4.3.5. Dedicated airport infrastructure to airport users**

According to the Commission's Report on the Implementation of the Airport Charges Directive, only a small number of airports have specific terminals dedicated to domestic and international routes, or to low-cost and full-service operations. The low-cost terminals are sometimes significantly cheaper in terms of the charges payable by airlines (up to 30% in some cases).

The subject of dedicated airport infrastructure refers to several State aid cases where airport managing bodies have provided tailor made infrastructure for a single airline, mostly low cost carriers like Ryanair. The Commission opened several procedures against airports to verify if a dedicated infrastructure built exclusively for one airline constituted an economic advantage. See for example the State aid case SA.15376 of Berlin- Schönefeld Airport and the State aid case SA.23324 of Tampere Airport.

Below is analysed the State aid case SA.23324 of Tampere Airport which is an example of dedicated airport infrastructure made for the purposes of a sole airline.<sup>80</sup>

Tampere-Pirkkala Airport is owned and managed by Finavia, a state owned airport managing company. The airport managing body had one operational terminal for all carriers operating at Tampere-Pirkkala Airport. Then Finavia decided to convert the redundant cargo hangar at the airport into a low-cost terminal. The operator of the terminal is Airpro, a subsidiary of Finavia. This terminal was reconstructed exclusively for Ryanair with whom the airport managing body concluded the service agreement in 2003.

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<sup>80</sup> Commission Decision of 25 July 2012 on measure SA.23324 - C 25/07 (ex NN 26/07) – Finland Finavia, Airpro and Ryanair at Tampere – Pirkkala airport, OJ L 309, 19.11.2013.

The Commission carried out a formal investigation to find out if reduced airport charges provided by Airpro to Ryanair constituted economic advantage to the airline and whether Finavia cross-subsidised Ryanair terminal from revenues of the first terminal.

The Commission found out that Ryanair paid the same landing, terminal navigation and security charges as airlines operating at the main terminal. Ryanair paid lower passenger charges and ground handling fees because the quality of services provided to Ryanair and consequently to its passengers were lower compared to the main terminal. Based on analysis made, the Commission concluded that differentiation of airport charges in both terminals was justified.

Like in the case of the State aid C12/08 of Bratislava Airport, the Commission in the State aid decision SA.23324 of Tampere Airport used the “full-cost approach” where it considered all operating and investment costs applicable to the measure in question.

The operating revenues included both aviation and non-aviation revenues. Operating and investment costs were attributed to the concluded agreement although the methodology of cost attribution was not explained in the State aid decision.

The business plan prepared by Finavia and submitted by the Finnish authorities demonstrated positive NPV of the agreement between Airpro and Ryanair. At the end the Commission concluded that Airpro acted like a market investor when it concluded the agreement with Ryanair. In addition, the Commission concluded that Finavia as well acted as a market economy operator because it decided to convert idle hangar into a passenger terminal in the situation of positive air transport market expectations in the low cost segment. Low cost carriers did not want to use the main terminal because they did not want to accept higher price of ground handling services.

In addition to analysis above, Berlin-Schönefeld Airport can be considered as an example of “dedicated airport” (see Chapter 4.3.2.4).

#### **4.4. Availability of infrastructure to all airport users**

The openness of an airport infrastructure is part of the assessment of an economic advantage to an undertaking and it is a supplement of the MEO test. According to the case law of the Commission, the airport infrastructure must be open to all airport users.

With regard to the agreement concluded between the airport managing body and Ryanair in the State aid case C/12 08 of Bratislava Airport, the agreement was concluded on non-exclusive basis. That is to say, all airlines operating at the airport had equal rights to conclude similar agreements if they wanted to offer an equivalent volume of activity compared to Ryanair.<sup>81</sup>

The Commission in the State aid case SA.18855 of Aarhus Airport observed as part of the assessment of economic advantage that the airport infrastructure used by Ryanair was open to all airport users.<sup>82</sup>

Even if the infrastructure is open to all airlines willing to use it for economic activity, the terms and conditions of such use should be the same to all airport users on a non-discriminatory basis.

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<sup>81</sup> Supra 27, recital 23.

<sup>82</sup> Supra 73, recital 111.

In this regard airport charges have to follow the criteria set forth in Chapter 3 where the main principles of the Airport Charges Directives are explained. Exemption or economic advantage to an airport user cannot be placed under the excuse of “commercial negotiation”. If this is a commercial negotiation, should not the airport managing body have similar commercial negotiations with all airport users in question? Even if the airport’s infrastructure is open to any user, is there a real competition between the airlines in question?

An airport may be profitable from an incremental agreement but it may not prevent the distortion of competition among airport users. A new market entrant can benefit at the expense of former airlines operating at an airport.

Referring back to the State aid case SA.15376 of Berlin-Schönefeld Airport, the Commission analysed at least eight agreements concluded between the airport managing body and airlines.

The main conclusion resulting from the above mentioned case is that an airport can offer different service charges to various clients as long as this business strategy increases net revenue of the airport. However, it remains unclear from the decision of the Commission if a market operator would have to extend this kind of treatment to all similar clients, not only the ones analysed in the State aid case.<sup>83</sup>

In author’s view, the openness of airport’s infrastructure is necessary condition but is it as not a sufficient condition to avoid granting economic advantage because the principle of non-discrimination with regard to application of airport charges has to be ensured as provided in the Airport Charges Regulation.

## Conclusion

Although State aid law provides legal basis concerning the assessment of granting an economic advantage to undertakings, in particular the MEIP, application of this legal and economic concept still remains ambiguous. The evidence is continuous complaints of competitors to the Commission and actions brought to the CJEU.

The basic principle set forth in State aid law with regard to price differentiation of airport charges is straightforward: it is allowed if a rational market economy investor would have done the same guided by medium to long-term profitability prospects.

In author’s view, the Master’s Thesis supports the hypothesis that differentiated pricing policies of the EU airports may not always be commercially justified to comply with the MEO test. This is of particular relevance to regional airports which, according to the Commission’s classification, service less than 3 million passengers per annum.

The analysed State aid cases of the Commission and judgements of the CJEU involves the assessment of commercial transactions between airport managing bodies and low cost carriers. The on-going legal debate is between low cost airlines on one side and full service carriers on the other side. After liberalisation of the EU air transport market, low cost carriers have become major clients of regional airports because they offered services at lower prices to customers and were less demanding with regard to the quality of airport services and infrastructure. As an alternative to “arrogant” full service airlines, airport managing bodies

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<sup>83</sup> Phedon Nicolaides, “A Market Operator Does not have to Treat all Customers Equally,” in *State Aid Uncovered. Critical Analysis of Developments in State Aid 2015*. (Berlin: The Lexxion Publisher, 2015), pp. 96-103.

accept the business model of low cost carriers because it is merely the only chance to make the airports flourishing.

The following main conclusions are provided below with regard to price differentiation according to the business situation of an airport:

- a) Price differentiation can be accepted on terms and conditions set forth in a commercial agreement between an airport managing body and an airline if an airport user (airline) is the sole operator at the airport and there is little evidence that other airlines will be attracted to the airport.
- b) The openness of an airport's infrastructure to other airport users is necessary but not sufficient precondition to avoid granting an economic advantage. To prevent distortion of competition, other airlines have to be offered the same terms and conditions of a commercial agreement compared to an airline under consideration provided that other airlines deliver similar service volume and require similar quality of service. Such policy would ensure a non-discriminatory application of airport charges to all airport users.
- c) Price differentiation can be accepted at an airport with multiple airport users if dedicated infrastructure (landside infrastructure - airport terminal, airside infrastructure – aprons, aircraft parking stands) is provided solely for the purposes of a single airline. However, also in this case a non-discrimination of airport charges with regard to other airport users has to be ensured to finance the airport's investment and operating costs of an airside infrastructure (runway, taxiways etc.) and remaining landside infrastructure.
- d) Price differentiation is questionable in cross-border airports of Member States which provide different legal framework with regard to treatment of non-economic activities of airports. Those airports which benefit from public funds in financing of non-economic activities like security and firefighting are in a better competitive position compared to those airports where costs of non-economic nature are attributed as economic costs and included in airport charges.

Further are provided conclusions with regard to the main constituent parts of the MEO test used in the case law.

#### *Ex ante analysis*

According to the case law, it is necessary to “place oneself“ in the period when the measure at issue was taken. In this regard the legal form of such placement is not determined. In author's opinion, *de facto* ex ante assessments of the MEIP have to be distinguished from retroactive (restored) MEO tests which are the majority of cases in the Commission's decisions. A prudent market investor most likely would make a material business decision including its formal approval in the form of a business plan and official authorisation on behalf of management or shareholders.

#### *Incremental contribution to profitability*

This principle includes the features of entirety of a measure, cost recovery, rate of return on the investment and long term perspective. The main findings are provided below.

The principle as such is not very straightforward in State aid law and is interpreted on case by case basis. While it is clear that that a measure in question has to contribute to the profitability

of an airport managing body, it does not necessarily mean that true incremental costs and revenues are taken into account in the MEO test.

In fact, the only two baseline State aid cases referred to in the Aviation Guidelines – the State aid case C 12/08 of Bratislava Airport and the State aid case SA.23324 of Tampere Airport - use the “average cost” approach instead of the “incremental cost” approach. The full cost base of an airport is selected first. Then, like in the State aid case C 12/08 of Bratislava Airport, part of these costs are attributed to the agreement with the airline *pro rata* the combination of “cost allocation keys” (passenger share, maximum take-off weight of an aircraft, aircraft movements at the airport and airport’s administration).

In author’s view, this is a fair methodology which eliminates the discrimination of airport users because the fixed costs of an airport (approximately 80% of all investment and operating costs) are taken into consideration.

The assessment of a measure should include all attributable features of a commercial transaction which could also include a joint assessment of several concluded agreements. For agreements among airport managing bodies and airlines it means inclusion of non-aviation revenues as well as costs of marketing and financial incentives. The revenue and costs categories are sometimes neglected in the MEO tests.

State aid law differentiates the prospects of profitability of a measure versus the impact of the measure to the long term profitability of an airport managing body. A prudent market investor is guided not only by short-term profitability but it could also prefer a medium to long term profitability. In this regard the MEO tests are carried out for the entire duration of a measure.

A commercial transaction should contribute to the airport’s overall strategy leading to profitability in the long term. This is a rather controversial issue.

Regional airports which receive operating or investment aid from public sources may treat the existing or historical costs as sunk costs. They focus less on the *ex ante* analysis of a commercial transaction including possible options in the market. Instead, they are ready to increase the traffic volume and accept the commercial conditions of airport users even if they provide a small incremental contribution to cover the costs of an airport. If the award of State aid continues in the future like in the case of Aarhus airport, society in general cross-subsidises lower airline tickets through compensation of an airport’s costs and reduced airport charges.

On the other hand, airports like Berlin-Schönefeld Airport which is rather not a regional airport, adopted an *ex ante* strategy to differentiate airport charges, increase the traffic volume and become financially sound in the medium term period.

For the purposes of the Master’s Thesis the author made a calculation of the hypothetical rate of return on the investment by applying the WACC method (in particular the CAMP). The comparison with the cost of capital (discount rate) used in the State aid cases shows that hypothetical cost of capital is similar to the discount rates applied in the Commission’s decisions. The CAPM is rarely used in the MEO tests of airport managing bodies and airports applying it are non-regional airports. One of possible explanations is that there are few airports quoted in the stock exchange.

However, the Commission also applies the reference rates according to the Commission Communication on Reference and Discount Rates as a proxy of a discount rate in situations where it does not have financial data from Member States. Such reference rates underestimate

the true opportunity cost of capital of a private investor because they show the lending rates of financial markets and not the expected return of a market operator. This conclusion coincides with the comment above on the application of real (*de facto*) ex ante assessments.

#### *Availability of infrastructure to all airport users*

Access to infrastructure is not a direct constituent part of the MEO test but it is used as a supplement to analyse the existence of economic advantage. As mentioned above, this is not a sufficient criterion because in certain circumstances it may abuse the principle of non-discrimination of airport charges in situations where new airport users benefit from using the airport's infrastructure and services while old users are paying the entire bill (i.e. most of the fixed costs of infrastructure and services).

The question remains if other airport users are able to gain the same benefits compared to the first market entrant which signed the agreement with an airport managing body and thus benefitted from differentiated airport charges.

State aid law with regard to price differentiation has to comply with sectoral law. The Airport Charges Directive is well tailored to address the main legal aspects of business co-operation among airport management bodies and airport users: non-discrimination, compulsory consultation, transparency, involvement in development plans, service standards and price differentiation. The issue is that this directive is applicable only to airports with the number of passengers exceeding 5 million per annum and to the biggest airport in a Member State.

It is worth considering the application of the Airport Charges Directive to airports of passenger volume below 5 million passengers per annum and to adjust to the threshold of the General Block Exemption Regulation for regional airports (determination of exact threshold is outside the scope the Master's Thesis). If the Airport Charges Directive were applied at least to part of regional airports, it would foster the implementation of a level playing field for all commercial airports in the EU. It is likely that there would be less complaints to the Commission concerning unlawful aid.

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